INVESTMENT TRUSTS AND INVESTMENT COMPANIES

HEARINGS

BEFORE A

SUBCOMMITTEE OF THE COMMITTEE ON BANKING AND CURRENCY UNITED STATES SENATE

SEVENTY-SIXTH CONGRESS

THIRD SESSION

ON

S. 3580

A BILL TO PROVIDE FOR THE REGISTRATION AND REGULATION OF INVESTMENT COMPANIES AND INVESTMENT ADVISERS, AND FOR OTHER PURPOSES

PART 3

EXHIBITS

Printed for the use of the Committee on Banking and Currency

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CONTENTS

EXHIBITS

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National Aviation Corporation,
New York, April 24, 1940.

Committee on Banking and Currency,
United States Senate, Washington, D. C.

Gentlemen: National Aviation Corporation is an investment company specializing in the aviation industry, including the furnishing of new capital from its own resources for new ventures in that field. Senate bill No. 3580, if enacted in anything like its present form and content, might so adversely affect the interests of our 3,400 stockholders, that we feel obliged, in their interests, to go on record in opposition to certain features of the bill.

We have not asked to testify at your hearings because the point of view of our branch ("closed-end management") of the investment industry on the wider aspects of the bill—such as the very broad control (without prescribed standards) given the Securities and Exchange Commission to regulate not only the general functioning of the industry but the business policies and detailed operations of the individual companies—have been adequately presented by others. The sphere of activities of our company, however, is so much more specialized and limited, and its field of investment so distinctive, that we feel justified in detailing these special features and in commenting upon provisions in the bill which are especially damaging in our situation. Also, we respectfully ask that this letter be incorporated into the record of the hearings.

FACTS ABOUT NATIONAL AVIATION CORPORATION

Our company is a New York corporation, organized in 1928 by a group who desired to foster and participate in the growth of the American aviation industry through investment. The only securities ever authorized by the company have been stock, all of the same class and with identical attributes. Stock was offered to the public in 1928 and 1929, but none since. The company is not in debt; its policy is not to borrow; it has never bought or sold on margin, and since 1931 has kept its portfolio in safekeeping with Guaranty Trust Co., New York City, under a strict custody agreement. On the basis of present market values, our portfolio (consisting of securities in 22 aviation companies) and cash are worth about $8,700,000 out of a net worth in excess of $10,000,000. Except for a wholly owned subsidiary operating Washington Airport, a small aviation research subsidiary, and a small subsidiary owning undeveloped real estate, our company does not directly or indirectly control any of the companies whose securities it owns. These securities are almost all common stocks, and the highest percentage of stock of any company (except the subsidiaries) which we own is 6.8 percent. The highest percentage of our assets invested in the stock of any one company (except the Washington Airport subsidiary) is 8.5 percent. The stock of National Aviation Corporation is listed on the New York Stock Exchange. A stock dividend was paid in 1929 and cash dividends in 1936, 1938, and 1939. The company is managed by a board of 10 directors, all of whom have had many years of experience with the aviation industry, its financing, dealings in aviation securities, or in investment generally. As stated, we have more than 3,400 stockholders.

The aviation industry, in which our company invests and reinvests its funds, is, as the committee doubtless appreciates, still adolescent and relatively small. It is highly competitive, changes rapidly, is subject to wide fluctuations, and is speculative.

CLASSIFICATION PROBLEM

National Aviation Corporation is a "closed-end management investment company" and a "securities finance company," within the definitions of the bill.

We submit, however, that from the functional standpoint, our company is

really the type of enterprise contemplated to be included within the definition of "diversified investment company," and entitled to such benefits as might accrue from such classification; but because of the 5-percent limitation in section 5 (b) (1) (a)—unreasonable of application to a company like ours which specializes in a comparatively small industry—we are outside that classification.

True, section 5 empowers the Securities and Exchange Commission to make "further classifications and subclassifications" of investment companies, but without prescribing or indicating standards of any sort. We feel that this is too uncertain. We, therefore, recommend that any legislation like S. 3580 contain at least one classification for companies which confine their investments to a particular field. The absence of such special classification from the present bill is especially serious in connection with taxation. Relief, on the same principle and to the same extent as extended to open-end investment companies by the Revenue Acts of 1936 and 1938 should be extended to companies like ours. The man of small means who purchases shares of our company for purposes of diversifying and getting expert judgment and management (essential in connection with an industry like aviation), now finds himself subjected directly and indirectly to a tax burden far greater (because of the relatively high corporate income-tax rate—plus the tax he pays on dividend distributions) than would concern him if he had invested directly for his own account.

Also, we point out the uncertainties confronting management arising out of the combination of sections 5 and 13 whereby a company like ours, for which it is vital to be able to act with great rapidity in shifting its investments from certain companies or groups (e. g., manufacturing as against transport) within the aviation industry, might have to take time to get advance stockholder approval of a buying and/or selling program (perhaps too late to be of avail) for fear this might be deemed by the Commission a change of fundamental investment or management policy.

MANAGEMENT RESTRICTION PROBLEM

To manage our company in the interests of our stockholders there must be on the board of directors and as principal executive officers, men who are able, experienced, and of standing in (*a*) the aviation industry, (*b*) the vocation of investment generally, and (*c*) the securities business, especially as related to aviation securities.

Four members of our board of directors hold directorates in a total of nine important aviation companies. Five of our directors are partners in brokerage firms and have been particularly helpful in the affairs of this company.

Under one or more of the provisions of sections 9 and 10 we should certainly lose 6 of our 10 directors (including the chairman), and possibly the other 4 members, too, through automatic disqualifications, resignations to retain other affiliations (in many cases their primary interests), or resignations to avoid individual registration requirements which can be made oppressive. We do not see how or whence (again emphasizing the specialized field of National Aviation Corporation) substitutes qualified under the bill, and willing to serve, can be found, who have the requisite competence, experience, and standing to manage substantial investments in aviation securities. Particularly in a specialized field will section 10 eliminate as officers and directors, men who are directors and officers of leading subjects for investment, because the investment company usually will, in the interests of conservative diversification, own less than 5 percent of their outstanding voting stock.

POLICY RESTRICTION PROBLEM

Any change of investment or management policy which really is fundamental, should be authorized or approved by the stockholders. But, in the case of a company like ours, investing only in specialized industry, it is important for the management to be able to decide and act quickly in time of need, especially as to buying and selling programs. Consequently, at least in the case of such investment companies, it is unwise, and may well be destructive of proper management, to require prior stockholder approval. Most alarming of all, however, is the blanket power given to the Securities and Exchange Commission to designate those investment and management policies which are fundamental. Whatever may be said about this from the standpoint of the general investment company, we submit that dependence upon the making and limitations of such designations, is inappropriate in connection with a highly specialized industry

like aviation. For example, in the absence of a designation—or a clear designation—the board of directors will have to make immediate decisions at their peril, with respect to purely investment action.

DIVIDEND RESTRICTION PROBLEM

Clause (B) of subparagraph (2) of section 19 (a) appears to apply to closed-end companies though we believe it was intended to relate only to "open-enders." Application of the clause to the former—especially to a company like ours, whose principal source of income from its aviation investments is necessarily not interest and dividends, but realized capital appreciation—impresses us as conducive to great difficulty and inordinate expense. We cannot visualize how the provision will operate as a practical matter, either from the standpoint of the stockholder or that of conservative capital management.

STOCK OWNERSHIP RESTRICTION PROBLEM

We submit that the prohibition against ownership of the stock of an investment trust by another investment trust contained in subsection (c) of section 12 of the bill should be modified, by some raising of the crucial percentage, probably to 10 percent, so as to make it practically possible for general investment companies to hold stock in an investment company specializing in a particular industry. A unit of investment of 1 percent of our stock would be much too small to serve the purposes of a large general investment company. We believe that investments by such companies in stocks of specialized companies like National Aviation Corporation should be encouraged, and that, for example, instead of attempting itself to diversify an investment between units in the aviation industry and incur the substantial expense of maintaining a specialized research department for the purpose, the general investment company may prefer, with wisdom, to have such diversification made and maintained for it, with considerable economy, through the medium of the specialized company's management who are experts in the particular field.

The point just made, we suggest, is another consideration for according special classification and treatment to the specialized investment company.

CONCLUSION

One complaint currently and widely made of the economy of the United States, is the "drying up of reservoirs of venture capital for new industry." National Aviation Corporation has been such a reservoir, nourishing in divers ways America's most promising young industry. The specialized investment company, particularly when capitalized only with stock of one class sold as a speculation, is particularly well adapted to fulfill that function. But it can continue to do so only under such regulation as recognizes business practicalities.

Yours very truly,

NATIONAL AVIATION CORPORATION,
By FRANK F. RUSSELL, *President.*

POOR'S PUBLISHING CO.,
New York, April 22, 1940.

Re Senate bill No. 3580, title 2.

To the COMMITTEE ON BANKING AND CURRENCY,
United States Senate, Washington, D. C.

GENTLEMEN: It is not my intention or desire to appear in opposition to the underlying purposes of this bill. Some form of governmental regulation seems desirable both from the standpoint of the investing public and from that of the profession itself.

My plea is directed toward a simplification and clarification of the wording of the bill. As now written, it contains so many broad provisions and generalities that, in effect, it would not be a law but rather an open-end authority to the Securities and Exchange Commission to regulate the entire profession of investment counseling as they might deem desirable.

I wish to be recorded in opposition to the granting of such broad general powers to any governmental commission, as I believe such authority should be retained by the Congress and not be delegated to others.

Any bill which may be passed for the purpose of regulating the business or profession of investment counseling should be both clear and definite in its provisions, so that everyone concerned may know just what is to be required, and the substance of whatever regulations are to be applied.

Furthermore, any bill should be carefully studied as to its effects on both the rather recently developed profession of personal investment counseling and the business of publishing financial statistics and analyses such as has been carried on for many years by such firms as Poor's Publishing Co., Standard Statistics Co., Moody's Investor's Service, and others.

In my opinion, the framers of this bill have not clearly thought through the effects of a number of its provisions on this latter type of investment analytical and advisory organization.

Again expressing my sympathy with the underlying purposes of this bill, I respectfully request that it be studied more carefully as to its effects on all types of business which would come under its control, and that it then be redrafted in simpler and more definite form.

Presented by,

PAUL T. BABSON,
President, Poor's Publishing Co.

NORTH AMERICA INVESTMENT CORPORATION,
San Francisco, April 12, 1940.

Hon. ROBERT F. WAGNER,
Chairman, Committee on Banking and Currency,
The United States Senate, Washington, D. C.

DEAR SIR: We wish to take this opportunity to express to your committee our views regarding Senate bill 3580, entitled "A bill to provide for the registration and regulation of investment companies and investment advisers, and for other purposes."

We have extensively reviewed the provisions of the bill with respect to its possible effects, not only as applied to our particular companies but to the investment-company industry as a whole. While we do not wish to protest against the enactment of legislation designed primarily to regulate the industry so as to eliminate former abuses and past unsound practices of some investment companies, we do object to the enactment of the bill in its present form for the following reasons:

1. Many provisions of the bill go far beyond the scope of necessary or required regulation. The practically unrestricted authority delegated the Securities and Exchange Commission to issue rules and regulations governing almost every phase of investment-company operations gives the Commission far too broad legislative powers.

2. The bill would add substantially to the expense of investment companies' operations by requiring further costly registration statements and reports to the Securities and Exchange Commission in addition to such expenses that might be occasioned by subsequent rules and regulations prescribed by the Commission under the discretionary power delegated to it in the act. This particular feature of the bill would operate most disadvantageously to the smaller investment companies by the disproportionate increase in expenses that would result from such costs.

3. The bill makes it practically impossible for persons presently connected with any phase of investment-company operations to form or assist in the formation of new investment companies even though through experience, proven ability, and other qualifications they may be the most able to engage in such undertaking.

While we disagree with many of the specific provisions of the bill, the above objections are, in our opinion, a few of the essential difficulties that would arise in the event the bill were passed in its present form.

We regret that we are unable to request the opportunity to appear before your committee as we feel the expense of a trip from the west coast to Washington would not be warranted by the size of our companies, but trust that this letter will serve the purpose of setting forth in a very general way our views regarding this proposed legislation.

Very truly yours,

LOUIS W. JENKINS, Jr., *Secretary.*

Hon. DAVID I. WALSH,
Senate Office Building, Washington, D. C.

MY DEAR SENATOR WALSH: I am one of the many individuals in Massachusetts serving as a fiduciary for members of my family and others and also serving as a general adviser on business affairs and other matters to members of my family and others in whom I have an interest. In some cases I act as trustee, guardian, or conservator, and in others I act under a power of attorney. I have never held myself out to be an "investment counsel" or "investment adviser," but in connection with the administration of the affairs of those who come to me I have on occasions found it necessary to give advice on the matter of investments.

I receive remuneration for my services on the basis of a fixed percentage of the income at a rate not in excess of the rate generally approved by our courts as reasonable compensation to fiduciaries for services rendered in the continuing administration of an estate. This rate is generally 6 percent of income. The rates charged by reputable investment-counsel firms who are equipped with research organization vary somewhat, but are in general about one-half percent of principal per year. I have never advertised nor have I ever held myself out to be equipped with a research organization or to be an expert on matters of investment.

My attention has been drawn to the definition of the phrase "investment adviser" in title I, section 45, of Senate bill No. 3580, introduced by Senator Wagner and seeking to regulate investment companies. If this definition stands as now worded and the bill is passed, it would require the registration with the Securities and Exchange Commission of myself and many thousands of other individuals in a similar position all over the country unless the Commission should otherwise order. An examination of the bill, of the report of the Securities and Exchange Commission, and of so much of the testimony of witnesses before the Senate Banking and Currency Committee as has come to my attention at this date leads to the conclusion that the primary intent of the bill is to regulate investment companies and investment counsel, so called. I have found no reference to those in my position. Furthermore, under chapter I, section A, of the report of the Securities and Exchange Commission on Investment Counsel filed in connection with this bill, the statement is made:

"As a consequence the Commission did not make the same type of study and investigation of investment counsel services as it did of investment trusts and investment companies. Detailed studies were not made, either through questionnaires or field investigations of individual investment counsel organizations, to ascertain the economic functions performed by or possible defects and abuses existing in these organizations."

It would seem that the comprehensive type of regulation of investment counsel contemplated by the bill under title II should not be attempted without detailed study. Prior to the enactment of such legislation there should be presentation of very convincing testimony to the effect that such regulation would prevent repetition of existing abuses, and would be for the public good.

From examination of some abuses in the investment-company field the Commission has discovered what it considers to be abuses committed by those giving professional advice on investments to others than investment companies. Without a detailed examination of these latter abuses the sponsors of this bill propose regulation not only of so-called investment counsel, but of all others in the country who are engaged in the business of advising others as to the advisability of investing in, purchasing or selling of securities (with certain specific exceptions). Apart from the administrative problem inherent in the registration of so many individuals, an extension of the powers of the Commission into this larger field does not at this time appear to be warranted by the facts or in the public interest.

In the event that Congress should decide that some sort of regulation of investment companies and investment counsel is necessary at this time, I suggest the following wording for title I, section 45 (a) (16):

"'Investment adviser' means any person who advertises, through the press, the mails, or otherwise, that he is engaged in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing or selling securities, and who receives compensation for said advice, or who, for compensation, advises investment companies as defined in this Act as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses

of reports concerning securities, but does not include (A) a bank, (B) any lawyer, accountant, engineer, or teacher whose performance of such services is incidental to the practice of his profession, (C) the publisher of any bona fide newspaper or magazine of general circulation, (D) such other persons not within the intent of this paragraph such as the Commission may designate by rules or regulations or order."

This wording varies from the wording as proposed in that with certain specific exceptions it includes under the definition "investment adviser" only those who advertise as such.

If the suggested wording above is for some reason considered inadequate, a possible alternative wording would be as follows:

"'Investment adviser' means any person who, for compensation, is primarily engaged in the business of advising others, either directly or through publication or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses of reports concerning securities, but does not include (A) a bank, (B) any lawyer, trustee, accountant, engineer, or teacher whose performance of such services is incidental to the practice of his profession, (C) the publisher of any bona fide newspaper or magazine of general circulation, (D) such other persons, not within the intent of this paragraph, as the Commission may designate by rules or regulation or order."

This wording varies from the wording as proposed in three respects:

In the second line the original wording is "engages", and has here been changed to "is primarily engaged in".

In the ninth line, (B), the word "trustee" does not appear in the original bill.

In the tenth line the original bill reads, "is solely incidental". The word "solely" has been stricken out.

It would seem that the first of these two suggested alternatives is preferable and that in any case very minor changes in wording, such as suggested above, would be materially less harmful to a large number of individuals who otherwise would become subject to regulation.

Of course, as you know, a trustee, and those who act under a power of attorney in investing funds and do work similar to that of a trustee, here in Massachusetts and in New England, do not advertise for this business, as they more or less follow the same ethics as a lawyer and other professional men, and are considered professional men, but I don't think this is appreciated in other parts of the country.

I am taking the liberty of writing this letter to you, as I do not know Senator Wagner, and I shall greatly appreciate it if you feel that you can pass this information on to him.

With kindest regards, I am

Yours very sincerely,

Augustus P. Loring, Jr.

Railway & Light Securities Co.,
Boston, Mass., May 1, 1940.

In re: Investment trust bill, S. 3580.

United States Senate,
Committee on Banking and Currency,
Washington, D. C.

Gentlemen: Under date of April 19, 1940, I appeared before your committee in objection to the passage of S. 3580. Since that time, there have been submitted, on behalf of a substantial part of the industry, certain constructive proposals which for the most part would remove my specific objections to the bill. There are, however, two matters in these proposals which I believe would represent a source of concern to the stockholders of my company.

1. *Limitations on the issue of senior securities in the future are unnecessarily restrictive.*—Actually the coverage ratio is not significant unless the character of the underlying securities is taken into account. Where high-grade, short-term bonds are held in sufficient amount to cover the debt, only a small margin of such coverage is needed to make the debt safe and prevent the equity being wiped out. Accordingly, any mathematical restriction is likely to be unsuitable for different types of situations, and it would seem that disclosure should be relied on for protection of investors rather than rigid restriction applicable

to all companies. If, however, some mathematical restriction is to be imposed, consideration might be given to the restrictions on loans secured by collateral prescribed by the Federal Reserve Board under the Securities Exchange Act. There were numerous references in the testimony before your committee to these restrictions. I submit that the issue of debt represented by collateral debentures by an investment company is not necessarily more speculative than such collateral borrowings and there is no reason why the restrictions placed on the issue of debt by investment companies should be on a different basis. There are attached as exhibits Regulations "U" and "T" of the Federal Reserve Board now in effect. From these it will be observed that the asset coverage on debt incurred for the purchase of securities must be 166⅔ percent, at the time of the creation thereof.

Any restrictions on the issue of preferred stock should take into consideration the extent to which debt has been issued or is concurrently being issued. For example, in the case of Railway & Light Securities Co., the certificate of incorporation contains a provision that the company shall not issue additional debt and/or preferred stock, if thereby these senior securities will aggregate more than three times the value of the common stock, or in other words, an asset coverage of 133⅓ percent for the combined debt and preferred stock. Without such a dual restriction, the preferred limitation may be of little value. I submit the record of operations of Railway & Light Securities Co. since 1904 (described in my testimony to this committee) as evidence of the efficacy of such a restriction, and likewise as to the sufficiency of the 3 to 1 ratio of senior securities to common capital.

I also feel strongly that great injustice may be done to the interests of investors, if exception to these restrictions is not granted for refundings, reorganizations, and consolidations. These exceptions need be in part only, permitting the issue of debt and/or preferred by the reorganized or consolidated company subject only to the proviso that the asset coverage of the debt and/or preferred stock of the consolidated or reorganized company shall be at least as great as that of its predecessors immediately prior to the reorganization or consolidation.

Dividend restrictions based on an asset coverage are equally illogical because they, too, ignore the character of the assets giving this coverage. In the event that any such restrictions on dividends are placed in the act, they should not interfere with the disbursement of current interest and dividend receipts, provided that the senior capital is not thereby impaired. Furthermore, these restrictions should not infringe existing contract rights.

2. *The prohibition on so-called self-dealing is unnecessarily restrictive.*—I have great difficulty in distinguishing between so-called agency transactions carried out by affiliated persons and purchases from or sales to an affiliated person as principal, provided, however, that such purchases from and sales to affiliated persons are made (a) in marketable securities, (b) at prices not above the then current price, (c) only when the securities are being publicly offered (in the case of a purchase), (d) where the transaction is approved by an independent majority of the board, with prior disclosure of the profit, if any, and (e) where the extent of such profits, if any, are reported to the shareholders at periodic intervals. Such a restriction would adequately safeguard the public against "dumping," would permit the continuance of investment bankers on the boards of investment companies as a minority thereof and would enable the shareholders of investment companies to benefit from the purchase of attractive public offerings sponsored by such investment bankers.

General.—While not bearing directly on the proposals made by representatives of the industry, I would like to mention one further point. An examination of the testimony before your committee reveals several comments made with respect to the inconsistency between the market price and the liquidating values of the common stocks of closed-end investment companies. As a matter of fact, this condition exists at the present time not only with respect to investment companies, but also with practically all of the largest and best known fire-insurance company stocks. A tabulation is attached as an Exhibit A hereto of 10 of the largest and best known fire-insurance companies, running back to 1913, indicating that at the close of 23 of the last 27 years, these stocks were selling in the market at discounts from their liquidating values and often these discounts were substantial. In the balance of the years, you will observe that they sold at premiums and frequently the fluctuations from discount to premium and back again were extremely large. The figures represent an average of these stocks, but each individual one shows the same identical character-

istics. The experience of Railway & Light Securities Co. common stock running back to 1904 has been similar. In 23 years out of the last 27 years, it sold at a discount at the year end and in the other 4 years at a premium.

Very truly yours,

RAILWAY & LIGHT SECURITIES CO.,
JAMES H. ORR, *President.*

EXHIBIT A.—*27-year record of percent discount of market price from asset value of common stocks of 10 leading fire insurance companies*

AVERAGE OF 10 FIRE INSURANCE COMPANIES' COMMON STOCKS [1]

Dec. 31, 1913	22.5	Dec. 31, 1928	+35.8
Dec. 31, 1914	22.2	Dec. 31, 1929	+.3
Dec. 31, 1915	23.4	Dec. 31, 1930	9.6
Dec. 31, 1916	26.1	Dec. 31, 1931	22.9
Dec. 31, 1917	29.3	Dec. 31, 1932	22.7
Dec. 31, 1918	38.1	Dec. 31, 1933	20.2
Dec. 31, 1919	26.8	Dec. 31, 1934	7.2
Dec. 31, 1920	28.2	Dec. 31, 1935	+3.1
Dec. 31, 1921	34.7	Dec. 31, 1936	12.2
Dec. 31, 1922	34.2	Dec. 31, 1937	28.3
Dec. 31, 1923	27.8	Dec. 31, 1938	19.6
Dec. 31, 1924	12.2	Dec. 31, 1939	16.2
Dec. 31, 1925	.3		
Dec. 31, 1926	8.3	27-year average	15.6
Dec. 31, 1927	+31.3		

[1] These companies consist of the following: Boston Insurance Co., Continental Insurance Co., Federal Insurance Co., Fidelity-Phenix Insurance Co., Fireman's Fund Insurance Co., Hartford Fire Insurance Co., National Fire Insurance Co. of Hartford, Pacific Fire Insurance Co., Phoenix Insurance Co., and Springfield Fire & Marine Insurance Co.

MAY 1, 1940.

HON. ROBERT F. WAGNER,
Chairman of the Subcommittee of the Committee
on Banking and Currency of the United States Senate
in Connection with bill S. 3580,
Washington, D. C.

DEAR SIR: Although we have not yet had an opportunity to study in detail the framework for an investment company bill, which we understand was suggested to your committee by some representatives of the industry at the hearings last Friday, nevertheless there is one provision as to which we should like to make a further suggestion.

We appreciate the difficulty of drafting any bill to regulate an entire industry which will not result in hardships which may appear unjust to certain parts of the industry. From our hasty examination, it is our belief that the suggested framework as a whole is a most constructive suggestion.

Our purpose in writing this letter is to have on the record this particular point for the consideration of those persons who may undertake the draftsmanship of a bill along the lines of the suggested framework.

Item No. 9 of the suggested framework provides that 40 percent of the directors of an investment company shall be independent of the principal underwriters, regular brokers, managers, or investment advisers. Presumably the purpose of this provision is to insure that the directors are giving their undivided attention to the interests of the shareholders of the investment company and to guard against any possibility of a conflict of interest through the fact that they might be making a profit in some other capacity from the operation of the investment company.

The proposed framework in item No. 14 prohibits self-dealing, as principals, between insiders and investment companies and item No. 21 (e) of the framework requires periodic disclosure of any amounts paid to any director or interested person in the form of indirect compensation. We are entirely in favor of such requirements, having always been opposed to any form of self-dealing by the officers, directors, or trustees of such investment companies. Some investment companies have gone even further than either the suggested framework of the bill or the original S. 3580 and prohibit a director or trustee of an investment company from profiting as a broker, agent or otherwise from

transactions with the investment company, involving portfolio securities or other assets of the company.

It is our opinion that where such extreme prohibition is in force the underlying reason for requiring an independent board of directors has been removed. The only interest of directors in such case is to serve the shareholders and under such a set-up it is our opinion that all of the directors are independent in the true sense of the word.

Accordingly, we suggest that there be added to this item No. 9 an exception to the effect that the independent directors be not required in cases of open-end investment companies which by their charters or trust instruments have provided that directors or trustees of investment companies may not, as principals, buy property from, or sell property to, the investment company and also may not, as broker or agent, either directly or indirectly make any profit on transactions with the investment company, involving portfolio securities or other assets of the company.

We also would like to suggest that, in connection with any additional registration required under this act, that where companies have already filed or are currently filing information with the Commission under either the Federal Securities Act or the National Securities Exchange Act, provision be made that a cross reference to such filing and to such information be sufficient rather than require an additional filing of substantially similar information under the proposed act, at considerable trouble and expense to the investment company.

We are making these suggestions applicable only to open-end investment companies because we feel that the redeemable feature gives the shareholder the added protection of being able to take out his money at any time in case he does not like the management or the directors who serve him.

Respectfully,

EATON & HOWARD, INC.,
By W. ELLIOTT PRATT, Jr.,
W. ELLIOTT PRATT, Jr., *Treasurer.*
LOOMIS, SAYLES & CO., INC.,
By MAYNARD HUTCHINSON,
MAYNARD HUTCHINSON, *Treasurer.*

LAW SCHOOL OF HARVARD UNIVERSITY,
Cambridge, Mass., April 27, 1940.

Hon. ROBERT F. WAGNER,
Senate Office Building,
Washington, D. C.

MY DEAR SENATOR: There is one statement in the proposals for revision of Senate bill 3580 presented to your committee by Mr. Arthur H. Bunker which, if correctly reported in the press, ought not to go unchallenged. The statement to which I refer is that the provisions in section 19 of the proposed bill "which interfere drastically with existing contract rights are indefensible." Reasonable men may differ as to the wisdom of some of the provisions in section 19, but it is only beclouding the issue to talk about interference with contract rights. The effect of the section is to limit the power of boards of directors to pay dividends either out of paid-in surplus or out of surplus derived from capital gains. Under existing State laws, no one has a contract right to be paid dividends out of either of these sources. The situation is that the directors may, in their practically uncontrolled discretion, determine whether or not to pay such dividends.

In the case of paid-in surplus, the directors' discretion is even broader. Under the laws of most States, they and they alone determine what if any portion of the consideration which is paid for shares shall be treated as paid-in surplus. If, in the exercise of such discretion, they create paid-in surplus, they then have discretion to retain it in the business or to use all or any portion of it for the payment of dividends. They have in addition discretion to take action at any time which will make such surplus no longer available for dividends by transferring it to capital. In the case of capital gains, the surplus arises automatically if the gains are realized through actual sales of securities, though it is possible that, under the laws of some States, the directors have in addition discretionary power to treat unrealized capital gains—paper profits—as surplus available for dividends. However this may be, they have, with regard to this kind of surplus also, discretion whether to pay it out in dividends, leave it in the business as surplus, or make it permanently unavailable for dividends by capitalizing it.

The issue raised by section 19 is whether the very broad discretion with regard to dividends now given to boards of directors by most of our State statutes is so broad as to be dangerous to the investors' interests, and whether, if such be the case, the particular limitations which section 19 proposes to put upon that discretion are desirable limitations. To call the discretionary power of corporate managers to do as they please with respect to the creation of surplus and its use or nonuse for dividends a contract right of the owners of the enterprise is to invent a wholly fictitious contract for the purpose of seeking to arouse moral indignation based on the wholly unjustified assumption that somebody's contract rights are being destroyed.

I am sending copies of this letter to Mr. Bunker and Mr. Schenker.

Yours sincerely,

E. Merrick Dodd, Jr.

F. Eberstadt & Co., Inc.,
New York, April 29, 1940.

Hon. Robert F. Wagner,
United States Senate, Washington, D. C.

My Dear Senator Wagner: Pursuant to arrangements at the termination of the hearings of the Senate Committee on Banking and Currency on the investment trust bill, I would like to submit this letter as a supplement to the record.

On Friday, April 26, Mr. Carlile Bolton-Smith, attorney, general counsel's office, Securities and Exchange Commission, testified with respect to certain transactions which took place about 10 years ago involving Continental Shares and Foreign Utilities, using my name in several instances during the course of his testimony. I think it might be a reasonable inference from this testimony that in some way I determined or shared responsibility for the policies of Continental Shares and Foreign Utilities. While there is no flat statement to this effect in the testimony—the facts undoubtedly having been at the disposal of Mr. Bolton-Smith—through inference that impression is given, and it is wrong. Accordingly, I would like to make this correction for the record.

As Mr. Bolton-Smith states, Continental Shares was organized in 1926. I never even heard of it until shortly before my brief association with Otis & Co. after the market break in October 1929. It is quite evident therefore that I could not possibly have had any participation in its organization, plans, program, or conduct of its affairs prior to October 1929. The same applies to Foreign Utilities.

Subsequent to October 1929, while I was familiar in a general way with the business and policies of Continental Shares, I was never an officer, director, or so far as my recollection and records indicate, even a stockholder, except through my interest in Otis & Co. (which never at any time exceeded 10 percent) in whatever stock of Continental Shares Otis & Co. may from time to time have owned. Thus, I cannot be regarded as having been in control or responsible for the policies of Continental Shares or Foreign Utilities.

Turning to Foreign Utilities, which was also referred to in Mr. Bolton-Smith's testimony, I was never an officer, director, or stockholder in this company. Nor, so far as I know, did Otis & Co. or any of its partners other than C. S. Eaton, occupy any such office or ever own any shares in Foreign Utilities, or have any influence in, or relation with, Foreign Utilities whatsoever excepting a purely brokerage relationship.

There is only one respect in which I may have been said to have exerecised a definite influence with respect to Continental Shares and Foreign Utilities, and that was by my insistence, as a member of Otis & Co., that both of these companies reduce substantially or liquidate the amounts which they, respectively, owed Otis & Co., to which firm I owed sole and undivided allegiance. In negotiating the loan with the Chase Bank, I, being in New York, handled the preliminary conversations upon the initiative and at the request of W. R. Burwell, president of Continental Shares, who subsequently took over the discussions and arrangements.

I would like to emphasize that I am not attempting to explain or apologize for the transactions referred to on the part of Foreign Utilities or Continental Shares; simply that I had no participation, or authority, in these decisions or any responsibility therefor.

Looking back, it is my opinion that the unfortunate results of that situation, in spite of an independent board, were due (1) to self-dealing and (2) to excessive current borrowing. I have attended numerous hearings and read all of the testimony before your committee, and I know of no instance in which anyone from the industry has objected to the definite legal restrictions in the bill banning self-dealing and excessive borrowing.

The fact that Otis & Co. handled issues for certain of the companies, a substantial part of whose stock was owned by Continental Shares, seems to me to be beside the point. I know of no harm, or alleged harm, having come to either Continental Shares or Otis & Co. from this type of transaction.

Quoting from Mr. Bolton-Smith's testimony: "Witnesses have expressed the opinion that if the bill before this committee requires that a majority of the board of an investment trust be independent, there is no need of further restricting the membership of the board." No such suggestion came from me, as can be seen from an examination of my statement before your committee. My suggestion was that not only should a majority be independent of the minority, but that such majority should not be affiliated with each other, which is an additional qualification of very considerable importance, and, in fact, goes further than the terms of the present bill. I never suggested this as a panacea. My remarks, as stated, referred to sections 10 and 11, and it is not to be inferred therefrom that I objected to every other provision in the bill. The above suggestion, taken together with the very proper provisions regarding self-dealing and excessive borrowing, etc., would seem to me to afford complete protection against recurrence of such results as those outlined by Mr. Bolton-Smith.

Sincerely yours,

F. Eberstadt.

F. Eberstadt & Co., Inc.,
New York, April 26, 1940.

Hon. Robert F. Wagner,
United States Senate, Washington, D. C.

My Dear Senator Wagner: Referring to the testimony given before the Senate Banking and Currency Committee on the investment-trust bill at its hearing Thursday, April 25, by Francis T. Greene, Assistant Director, Trading and Exchange Division, Securities and Exchange Commission, I would like to correct what I and others, who have read this testimony, consider distinctly unjust and unfair implications tending to reflect on this firm.

At the outset, if my remarks to the committee in connection with reading the paragraph of Mr. Greene's letter did not make it clear, let me emphasize at this time that the reference to the letter was in no sense intended to reflect in any way on Mr. Greene. From our acquaintance with him we feel very sincerely that he is doing an excellent job. The paragraph was simply read as an example of the extraordinary difficulty which we and others in our business have in complying with the confusing, lengthy, intricate, and complex rules and regulations, in spite of every help and assistance that those on the Securities and Exchange Commission staff endeavor to afford us .

According to Mr. Greene's testimony, this firm "violated the reporting ruling by failing to file any reports showing transactions of the underwriting and stabilizing syndicate, as such, on the day of the offering."

One might fairly conclude from reading Mr. Greene's testimony that we had transgressed, in a willful and substantial way, some rule of the Commission with respect to stabilization, etc. This is not the case and I am sure that Mr. Greene would be the first to substantiate my statement in that connection.

However, he goes on to say that we "should have reported the details of this type of manipulation." I protest against and resent the use of the word "manipulation." Neither in this instance nor in any other, has this firm ever indulged in, or been accused of, manipulation of any sort, form, or manner. There was no question of "manipulation" involved in any way whatsoever and I think the use of that word in reference to this firm was highly improper.

Turning specifically to Mr. Greene's statement that "Eberstadt & Co. violated the reporting rule by failing to file any reports showing the transactions of the underwriting and stabilizing syndicate, as such, on the day of the offering," the facts are as follows:

Pursuant to rule X–17A, we were required over the period from December 7, 1939, to date, to file a total of 136 reports. All of these reports were filed and, so far as I am aware, were filed promptly. On March 21, 1940, it was called to our attention that the very first reports filed were deficient in two respects, namely, that they were filed by ourselves and the other underwriting firm concerned individually instead of being filed by us on behalf of the two firms jointly, and, secondly, that the amount of stock sold by us at retail was not given in the proper form. Both of these alleged deficiencies relate solely to the manner of reporting the facts involved and not to the adequacy of the

disclosures of these same facts already made as originally filed. In other words, we, in the course of conducting an entirely legitimate part of our business which, in fact, has been recognized as such by the Securities and Exchange Commission through the promulgation of these very rules, failed to report in the proper manner certain facts which, as a matter of substance, were already fully covered by reports which had been filed promptly and on the day that they were due. Certainly, we feel that this failure on our part is not subject to being criticized as "manipulation" or stigmatized as being the kind of violation which under any possibility could be the subject of "court proceedings."

To Mr. Greene's charge of confusion on our part, I am afraid we must plead guilty.

With respect to the reports in question and with respect to every other statute, rule, or regulation of the Securities and Exchange Commission, our record with the Commission from the time it was originally constituted, is clear and the sincerity of our desire to comply in the most punctilious way with these, to us at least, confusing rules and regulations is only equaled by the generous and cooperative way in which, not only Mr. Greene, but everybody else attached to the Commission, has been of help and assistance to us.

I understand that at the conclusion of the hearings today, those who had testified were to be afforded an opportunity to submit further memoranda. I would therefore greatly appreciate, in justice to this firm, the inclusion of this letter as such in the records of the committee.

Sincerely yours,

F. Eberstadt.

Securities and Exchange Commission,
Washington, May 1, 1940.

Hon. Robert F. Wagner,
United States Senate, Washington, D. C.

Dear Senator Wagner: Mr. F. Eberstadt has been kind enough to send me a copy of his letter to you of April 26, 1940, which he has asked to be included in the record of the hearings on S. 3580.

I do not wish to prolong the discussion as to the character or extent of Eberstadt & Co.'s violation of the Commission's stabilizing reporting rule (rule X–17A–2). Both the original incorrect reports and the corrected reports recently filed by this firm are matters of public record which I should be glad to explain to anyone interested in the details thereof. On the other hand, I should like to make the following comments with respect to some of the points mentioned in Mr. Eberstadt's letter of April 26.

(1) The statement which I made to your committee on April 28, of course, was in no wise intended to be susceptible to any inference that Eberstadt & Co.'s violations were willful. On the contrary, it was my assumption throughout that its violations were the result solely of mistakes—mistakes the recurrence of which I sought to prevent by my explanatory letter.

(2) The firm's failure to file a report covering all transactions by the underwriting and stabilizing syndicate, of which it was the manager, represented, at least in my opinion, a failure to comply with the rule sufficiently substantial in character to justify the detailed explanation made in my letter of March 27. The significance of this violation lay in the fact that the Commission, as a result, was in ignorance of the character or extent of the syndicate's activities on the offering date of the stocks in question.

(3) That stabilization is a form of manipulation is recognized not only by the Securities Exchange Act of 1934 but by the congressional reports recommending the enactment of that legislation. (See, for instance, H. Rept. 1383, 73d Cong., 2d sess., p. 10.)

(4) The failure of Eberstadt & Co. fully to comply with the reporting requirements of rule X–17A–2, of course, did not constitute "manipulation" nor was it so characterized by me.

(5) Insofar as Mr. Eberstadt's letter of April 26 again implies that the rules requiring the reporting of all details of stabilizing operations are "confusing, lengthy, intricate, and complex," I might explain that the risk of injury to the investing public involved in the use of the device of stabilizing is such as to necessitate detailed reports by underwriters as to how they use this device. I might add that the desirability of complete reporting of stabilizing transactions was recognized in a memorandum prepared by Morgan Stanley & Co., Inc., under date of March 24, 1938. In discussing the problem that banking house itself suggested the adoption of stabilizing rules which, among

other things, would require the daily filing by a stabilizer of a detailed report setting forth all purchases and sales made by the syndicate account in the public markets during that day.

If Mr. Eberstadt's letter of April 26 is incorporated in the record, may I request that this reply be also included.

Respectfully,

FRANCIS T. GREENE.

F. EBERSTADT & CO., INC.,
New York, May 3, 1940.

Hon. ROBERT F. WAGNER,
United States Senate, Washington, D. C.

MY DEAR SENATOR WAGNER: Mr. Greene has kindly sent me a copy of his letter to you dated May 1, which he requested be included in the record of the hearings on S. 3580.

I appreciate the spirit of Mr. Greene's letter. It removes the possible unfair and prejudicial inferences which seemed to me inherent in his testimony before your committee, which I felt sure were not intentional on his part.

I would like to close my end of this correspondence by reference to paragraph (5) of Mr. Greene's letter, in which he appears to find endorsement of the present Securities and Exchange Commission stabilizing procedure in a memorandum prepared by Morgan, Stanley & Co., under date of March 24, 1938. I fail to find support for Mr. Greene's point of view in said memorandum. Quoting from the bottom of page 35 of said memorandum: "The two sets of proposed rules on 'pegging, fixing, and stabilizing' which the Commission has prepared and submitted for criticism are so complicated that they would probably never be generally understood, and certainly never be workable," this would seem to me to be exactly what I originally stated to the committee on this subject.

Inasmuch as the previous correspondence on this subject has been included in the record, I would very much appreciate it if you would also include this letter in the record of the hearings on S. 3580.

Sincerely yours,

F. EBERSTADT.

CALVIN BULLOCK,
New York, May 2, 1940.

Re: S. 3580.

Hon. ROBERT F. WAGNER,
Chairman, Senate Banking and Currency Committee,
The United States Senate, Washington, D. C.

MY DEAR SENATOR WAGNER: In the recent hearings of the Senate Banking and Currency Committee on the investment trust bill (S. 3580), quite a number of references were made to the National Association of Securities Dealers, Inc., as a medium through which underwriters and distributors of open-end investment trusts might themselves, under governmental supervision, better solve the regulatory problems involved in the underwriting and distribution of shares of such trusts than such problems could be solved through the mechanism contemplated in S. 3580.

In the course of these hearings, and in connection with these references to the National Association of Securities Dealers, Inc., there were several questions about the association which led me to believe that it might be helpful to the committee to have before it, in its consideration of this bill, a descriptive statement concerning the association, its background, its legal relationship to the Securities and Exchange Commission, its objects, powers, nature, method of operation, and state of development at the present time. I am, accordingly, addressing this letter to you with that end in mind; and I earnestly request that it be made a part of the record of the hearings for that purpose.

The National Association of Securities Dealers, Inc., is registered with the Securities and Exchange Commission as a national securities association pursuant to the provisions of section 15A of the Securities Exchange Act of 1934, as amended.

You will recall that the so-called Maloney Act amendment to the Exchange Act (which, among other things, added section 15A to that act) was designed to provide for the establishment of a mechanism of regulation among over-the-counter brokers and dealers operating in interstate and foreign commerce or through the mails, comparable to that provided by National Securities Exchanges under the Securities Exchange Act of 1934. It came about as the result of cooperation between Senator Francis T. Maloney, the Securities and Exchange Commission, representatives of the investment banking and securities business and the deliberations and ultimate approval of your committee, and I think it is generally recognized as a highly significant and promising experiment in cooperative regulation by government and business.

More specifically, section 15A contemplates the formation of associations of brokers and dealers and their registration with the Securities and Exchange Commission for the purpose of providing such associations with effective means or sanctions to bring about self-regulation of association members, under governmental supervision. Such associations are thus enabled to promulgate and enforce, with Securities and Exchange Commission approval, such rules of fair practice as they deem necessary and appropriate to carry out the purposes of the act.

The National Association of Securities Dealers is the only association to date which has registered with the Securities and Exchange Commission pursuant to the provisions of said section 15A. Its registration statement became effective on August 7, 1939, at which time it had 1,469 members. Today it has 2,891 members, which are located in every State and in substantially every important city or town in the country, and it is believed that the present membership does well over 90 percent of the underwriting and general over-the-counter securities business of the country.

For purposes of administration, the country is divided into 14 districts, and each district elects a district committee which has general supervision and charge of the affairs of the association in its district. There is also a national board of governors of 21 members who are elected from the various districts, and the board of governors is the national governing body of the association.

The association has adopted some 25 rules of fair practice, and these are enforced by district and local business-conduct committees and by the board of governors.

In accordance with the provisions of section 15A of the Exchange Act, decisions of district business-conduct committees are appealable to the board of governors, from the board of governors to the Securities and Exchange Commission, and from the Securities and Exchange Commission to the Federal courts.

Section 15A gives such associations the right, by rule, generally to restrict the preferential dealings of members to members of such associations, and the National Association of Securities Dealers has adopted such a rule. In view, therefore, of the size and importance of its membership in the business, the fact that no other association has registered with the Commission, and the fact that a member expelled for violation of the rules may no longer deal with association members on a preferential basis, it can readily be seen that the association has effective economic sanctions for requiring compliance with its rules.

As I have already indicated, the association at present has 2,891 members, and since there are some 6,700 brokers and dealers registered with the Securities and Exchange Commission, it might be thought that the association covers only a part of the field to be regulated; but in this connection, I should like to call your attention to the fact that of the 6,700 brokers and dealers registered with the Commission, some 1,000 are largely brokers and dealers in oil royalties, and thus have no interest in membership in the association or in the provisions of S. 3580. By the same token, it is estimated that several hundred are dealers in real-estate mortgages and notes and some 700 are brokers or dealers who are solely connected with exchange trading; so that when the list of brokers and dealers registered with the Commission is thus broken down, I think it fair to say that only some 4,000 brokers and dealers can be said to be in the general over-the-counter securities business and thus interested in membership in the association or in the provisions of S. 3580. You will see, therefore, that roughly 75 percent of this 4,000 are already members of the association. Indeed, substantially all of the so-called open-end investment-trust underwriters are at present members of the association, and it is our belief that the vast majority of dealers who distribute shares of open-end investment trusts are already members of the association; so the association does afford an effective medium for

handling the regulatory problems which are sought to be reached by the provisions of S. 3580 insofar as they affect the underwriting and distribution of open-end investment-trust shares.

As a matter of fact, there is a standing committee of the Association of Investment Trust Underwriters which is charged with the duty of studying all aspects of the problem of underwriting and distributing shares of open-end investment companies with a view to formulating recommendations of appropriate rules and regulations, to be adopted as rules of fair practice of the association, governing this particular branch of the investment banking and securities business, and this committee is presently at work on the task assigned it and is hopeful of formulating a comprehensive regulatory program to be carried out through the association in the immediate future.

As the underwriting and distribution of shares of open-end investment trusts is after all an important branch of the general securities business; and as the Congress, on the recommendation of your committee, has already seen fit to provide for this mechanism of self-regulation, under governmental supervision, of this business, and as the National Association of Securities Dealers, Inc., has already registered with the Commission and is seeking to carry out the purposes of section 15A of the act, and as the investment trust underwriters and distributors are already proceeding through the association to develop a comprehensive regulatory program for their phase of the business, it is submitted that investment trust underwriters and distributors should be given a fair opportunity to effectively regulate their branch of the securities business through the Association as envisaged by the Maloney Act.

Very truly yours,

HUGH BULLOCK.

MAY 2, 1940.

Hon. ROBERT F. WAGNER,
Chairman, Subcommittee of the Committee on Banking and Currency,
Washington, D. C.

DEAR SENATOR WAGNER: During the hearings before your committee on S. 3580 the members of the staff of the Securities and Exchange Commission have minimized the effects of title II of this bill. In his rebuttal testimony on Friday, April 26th, in discussing this title Mr. Schenker made the following statements: "All we are asking them to do is file a piece of paper and say, Who are you? What's your name? What's your address? Have you ever been convicted of a crime? If you have been convicted of a crime, you have no business to be an investment counsel and you can't use the mails to perpetrate a fraud. That is the extent of this whole regulation on these people."

If this description could be regarded as a complete summary of the provisions of title II, it would indeed be difficult to see why the investment counsel profession is so seriously concerned about the effects of this bill.

Title II consists of more than 30 pages, over two-thirds of which are incorporated by reference from title I. Obviously no such long and complex bill is required to accomplish the purposes enumerated by Mr. Schenker.

In connection with the filing of the registration statement provided for in this bill and in addition to the information specifically mentioned in the text, the Commission is empowered to demand such further information and copies of such further documents relating to such investment adviser or its affiliated persons and employees as the Commission may by rules and regulations or order prescribe as in its opinion is necessary or appropriate in the public interest or for the protection of investors. This is hardly "Who are you? What's your name? What's your address? Have you ever been convicted of a crime?"

All of the enforcement provisions of title II are incorporated by reference from the title I. These provisions which were designed to meet the problems incident to the public's holdings of the securities of investment companies are thus transferred to cover the highly personal and confidential relationship existing between an investment counsel and his clients. They are not appropriate for this purpose, and they are more far-reaching than is necessary to accomplish the stated objectives of the Commission. Section 38 of the bill gives the Commission discretion and broad powers to investigate facts, conditions, and practices within our profession. These powers are not limited to the determination of whether a person has violated the law or is about to violate the law or to investigations in connection with the enforcement of the provisions of title II. Despite the broad scope of this bill, it contains no provisions to safeguard and

protect the interests of clients of investment counsel firms in the privacy of their affairs.

This letter is not intended to be a summary of our objections to title II of this bill. It is merely a statement of the more important reasons why we feel that Mr. Schenker's description of the effects of this title is not in accordance with its actual provisions as we read them.

We would appreciate having this letter printed as part of the record of the hearings before your committee.

Respectfully yours,

C. M. O'Hearn.
Douglas T. Johnston.
Dwight C. Rose.
Alexander Standish.
James N. White.

Boston, Mass., *May 2, 1940.*

Re: Investment company bill.

Hon. Robert F. Wagner,
Chairman, Committee on Banking and Currency, Washington, D. C.

Dear Sir: In accordance with the invitation of Senator Hughes on Friday, April 26, 1940, we wish to submit, with the request that it be included in the record, the enclosed statement.

Yours respectfully,

Paul C. Cabot,
President, State Street Investment Corporation, Boston, Mass.
Wm. Tuder Gardiner,
Chairman, Incorporated Investors, Boston, Mass.
Merrill Griswold,
Chairman, Massachusetts Investors Trust, Boston, Mass.

Memorandum for the Record of the Senate Banking and Currency Committee on Investment Company Bill S. 3580

On Wednesday, April 24, 1940, Mr. Schenker, testifying before the Committee regarding the tax treatment of mutual investment companies, said:

"I can state why, and I think I can state my difficulties with the tax discrimination. Unfortunately, Senator, there is no legislative history upon that provision in the tax law. As I remember it, it was introduced on the floor, and the first thing we knew was that the open-ended companies, as counter-distinguished from the closed-end company, had this tax preference."

The above statement is incomplete and we wish to correct it. In this connection, we have been told that Mr. Schenker will offer a correction of his testimony.

But inasmuch as reference to this matter has recurred from time to time, both at this hearing and prior thereto, and in order that the facts may be fully known, we wish to give herewith a brief history of that phase of the tax legislation.

In his Message to Congress on June 19, 1935, the President of the United States recognized that bona fide investment trusts that submit to public regulation and perform the function of permitting small investors to obtain the benefit of diversification of risk should receive special tax treatment.

As a result of this statement, late in 1935 and early in 1936 a group representing a large number of open-end companies had conferences with many individuals in the Treasury Department, with various Senators and Representatives and the President of the United States, relative to tax relief for investment companies. The more important of these interviews will be detailed below.

Prior to any of these conversations, Paul C. Cabot had an interview with Mr. James Landis, then Chairman of the Securities and Exchange Commission, in which Mr. Cabot outlined to the Chairman what specific tax relief this group sought and solicited the Commission's aid in respect thereto. In substance, Chairman Landis at this time stated that in view of the fact that the Securities and Exchange Commission was about to undertake an exhaustive study

of the investment trust industry, he felt that it was inadvisable for the Commission to initiate any attempt to change tax legislation in favor of or in opposition to investment companies. He did state, however, that he would be interested in knowing what, if anything, was accomplished along these lines. Because of this, the group kept Mr. Landis' assistant, Mr. Thomas H. Gammach, informed as to their procedure from time to time.

On June 12, 1936, the group met with Mr. Milton Katz, executive assistant to the Chairman, and related to him in detail what had transpired. At that time, Mr. Katz wrote a memorandum under date of June 12, 1936, a copy of which is hereto appended, marked "Exhibit A," which was marked to go to Chairman Landis, Mr. Schenker, and Dr. Gourrich.

On March 16, 1936, Merrill Griswold wrote President Roosevelt, urging that the taxation problems of investment trusts be most carefully considered in connection with the proposed new revenue bill. In the course of his letter, he said: "The Securities and Exchange Commission is at present making a thorough study of investment trusts and is consequently already reasonably thoroughly familiar with their taxation problems. I venture to suggest, therefore, that the views of the Commission be ascertained by the administration and by Congress as to how the interests of the shareholders of investment trusts can best be reconciled under the new law with the interests of the Government."

In reply, the President's secretary, Mr. Gaston, wrote Mr. Griswold that Mr. Morgenthau had asked those of his associates who were particularly studying the type of problem described to read the material submitted very carefully and to consider it in connection with other suggestions that were under discussion.

On March 11, 1936, an interview was requested with Mr. Guy T. Helvering, Commissioner of Internal Revenue, and under date of March 18 this interview was arranged for March 25. From Mr. Cabot's letter of March 11, we quote the following:

"I am most anxious to have an opportunity for a personal interview not only to go over the subject of my previous correspondence relative to section 102 of the Revenue Act of 1934, but also to present to you certain ideas relative to future taxation which have been brought about by the President's recent message."

On March 24, 1936, an interview took place with Messrs. L. K. Sunderlin, Hill, and McGinnis of the Department of Internal Revenue.

Under date of May 18, 1936, a letter was written by Mr. Cabot to Mr. C. E. Turney of the Treasury Department, from which we quote the following:

"Since that time I have had a very satisfactory talk with Messrs. Sunderlin, Hill, and McGinnis of the Internal Revenue Department. In talking with these gentlemen I had occasion to enter into a discussion with them as to the then pending House revenue bill (H. R. 12395) and left with them a memorandum, copy of which I am enclosing marked 'Exhibit A.' At their suggestion I also had at that time a talk with Mr. L. H. Parker, Chief of Staff of the Joint Committee on Internal Revenue Taxation, and left with him also a copy of exhibit A.

"As a result of these conversations we drew up certain Suggestions Regarding Treatment of Mutual Investment Trusts and Corporations under Revenue Bill of 1936, H. R. 12395, a copy of which is enclosed marked 'Exhibit B.' [1]

"About a week ago Mr. Griswold and my partner, Mr. Morton, were in Washington relative to these suggestions and at that time discussed the matter with Mr. Parker and various Senators on the Finance Committee; also with Messrs. Harlan, Brown, and Oliphant."

On Friday, May 8, 1936, Senator Walsh of Massachusetts introduced before the Committee on Finance of the United States Senate the memorandum hereto appended, marked "Exhibit B." (See Hearings Before Committee on Finance of United States Senate, H. R. 12395. U. S. Government Printing Office Publication No. 68545, p. 799.)

Under date of May 23, the memorandum above referred to marked "Exhibit B" was supplemented by a statement (herewith attached and marked "Exhibit C"), from which it will appear that we did not claim or urge that our proposal be limited to companies only that had redeemable shares.

On Tuesday, May 26, 1936, we had an interview in Senator Walsh's office

[1] Suggestions Regarding Treatment of Mutual Investment Trusts and Corporations under Revenue Bill of 1936, H. R. 12395, is hereto appended as exhibit B.

with Messrs. Lusk and Kent, of the Bureau of Internal Revenue, relative thereto.

During this entire period there were many conversations held with Senators and Representatives, and on June 3, 1936, the undersigned had an interview with the President relative thereto.

On June 5, 1936, Senator Walsh offered in the Senate certain amendments which he stated that the subcommittee had unanimously agreed upon (Cong. Rec., p. 9070). Such of these amendments as related to the taxation of mutual investment companies were adopted by the Senate and subsequently, with minor changes, made by the Conference Committee (which reported June 19, 1936), were enacted into law.

On June 12, 1936, as above-mentioned, the entire matter was taken up again with the Securities and Exchange Commission who at that time wrote the memorandum (exhibit A) appended hereto.

On October 19, 1937, the entire history as above-mentioned was again gone into in considerable detail in an interview by the undersigned with Commissioner Healy in his office, into which he called Messrs. Schenker and Gourrich.

On September 23, 1936, Mr. Paul C. Cabot, in his public testimony before the Securities and Exchange Commission, went into the subject of the Revenue Act of 1936, as it affected mutual investment companies, in great detail.

To complete the history of this tax matter, brief reference should be made to the 1938 Revenue Act.

The Vinson subcommittee of the Committee on Ways and Means transmitted their report on January 14, 1938. Recommendation No. 5 covered "mutual investment companies." (See pp. 10 and 66 of that report.)

Representatives of open-end and closed-end investment companies appeared at hearings before the Committee on Ways and Means on the bill that became the Revenue Act of 1938 (see pp. 809 and 827 of the record of hearings). Representatives of the Securities and Exchange Commission also appeared prior to passage of the bill, but at some executive session. The 1938 act provisions appear in section 361.

In view of all the above, we believe the remarks made by Mr. Schenker as quoted above are incomplete; that there was considerable legislative history upon this tax provision, and that the Securities and Exchange Commission were fully informed by us about it from start to finish.

PAUL C. CABOT,
President, State Street Investment Corporation, Boston, Mass.
WM. TUDOR GARDINER,
Chairman, Incorporated Investors. Boston, Mass.
MERRILL GRISWOLD,
Chairman, Massachusetts Investors Trust, Boston, Mass.

EXHIBIT A

JUNE 12, 1936.

Chairman Landis, Mr. Schenker, and Dr. Gourrich. Mr. Katz. Conversation with Messrs. Paul Cabot, Merrill Griswold, and W. T. Gardiner concerning "mutual investment companies"

Mr. Paul C. Cabot, president of the State Street Investment Corporation; Mr. Merrill Griswold, chairman of the Massachusetts Investors Trust; and Governor W. T. Gardiner, chairman of Incorporated Investors, are in Washington in connection with pending deliberations upon the tax bill. Their specific concern is with the impact of the bill upon investment trusts of a type hereinafter described, which they call "mutual investment companies." The character of these companies is best indicated in the definition of "mutual investment company" set forth in proposed section 1001 (15), a copy of which is attached hereto.

Under the terms of the original House bill, earnings paid out would not have been taxable except in the hands of the recipients. In consequence, this bill involved no serious problem for the mutual investment companies. It would merely have required them to pay out capital gains as well as income upon the securities in the portfolio, to earmark the capital gain as such, and to solicit reinvestment of the capital gain by the shareholders.

The Senate bill, however, as originally conceived, would have placed a very serious burden upon these companies by reason of its imposition of an income tax ranging up to 18 percent upon the income of the company, as well as the normal tax upon dividends paid by the company to its shareholders. (The Senate

bill, of course, imposed a 7-percent undistributed-earnings tax, which could have been avoided by distribution of the earnings.)

The Senate bill, as passed, however, contains a special provision for mutual investment companies as defined therein. This provision would enable such companies to deduct from taxable income all (or a very substantial part) of the earnings paid out to shareholders. The attached section 1001 (15) represents a modification of the definition of mutual investment companies, worked out by Messrs. Cabot, Griswold, and Gardiner with technicians at the Treasury. They hope that the modification will be embodied in the bill by the conference committee.

An interesting question that arises out of the provisions in the proposed bill is whether they will cover the situation of fixed investment trusts. Mutual investment companies, as defined, can avoid the tax only by paying out all earnings, including capital gains. The ordinary type of fixed trust does not have authority to pay out capital gains, and there is some question whether, in the ordinary case, they can conveniently amend their articles so as to make such payment lawful. I was informed that the Treasury expressed some concern over this question, and that Mr. Griswold suggested Dr. Gourrich as a source of information. It should be noted that the question may not be particularly serious for fixed trusts, inasmuch as changes in their portfolio do not occur often.

Exhibit B. Suggestions Regarding Treatment of Mutual Investment Trusts and Corporations under Revenue Bill of 1936, H. R. 12395

INTRODUCTION

The two Boston mutual investment trusts signing this document merely constitute a conduit through which 40,000 persons residing in practically every State in the Union have made investments in stocks of about 130 different corporations. Over a period from 1924 to date these 40,000 people have invested about $120,000,000 in these funds, the average investment being about $3,000 apiece. This $120,000,000 as of March 31 was worth approximately $140,000,000. Most of the shareholders are persons of moderate means, either not in the surtax brackets or else in the lower tier of such brackets, who do not have equal facilities with the wealthy to obtain expert supervision and diversity in their investments. It is in order to obtain these benefits that they have availed themselves of these funds which guarantee to redeem all or any part of their shares at any time at a price approximately equal to the liquidating value per share, which price of course varies from day to day with changing market conditions.

We, the managers of these funds, are anxious that any new tax bill shall not create any injustice to our shareholders and that so far as is possible it remedy existing inequities.

If investment corporations and investment trusts (which for taxation purposes are classed as corporations) provided they distribute their entire taxable income, are taxed under the new bill in effect the same as partnerships, the result on the shareholders will be fairer than under the present law. The present law is particularly unfair to shareholders of moderate means, who are not subject to surtax. Under existing law these people are today forced through their corporations to pay in taxes at the rate of at least 15 percent on gains, although if they had made the same gains directly as individuals, they only pay 4 percent. In the words of the Secretary of the Treasury, Mr. Morgenthau, on April 30 before the Senate committee "it will be well to bear in mind at all times that this is purely and simply a proposal to put all taxes on business profits essentially on the same equitable basis; to give no advantages and to impose no penalities upon corporation stockholders that are not given to and imposed upon the individual taxpayer."

If the partnership theory is adopted exactly (and to do this section 117 of the proposed bill must be slightly amended as hereinafter set forth), although the Government will receive increasing revenues from the shareholders of investment trusts, individual shareholders cannot complain as they will be equitably treated—whether subject or not to surtaxes. If, on the other hand, instead of adopting the partnership theory the flat rate on investment trusts, now 15 percent, is substantially increased and/or the present allowance for deduction of dividends, which is now 90 percent, is decreased, the existing inequities will be even further accentuated. Therefore, regardless of the merits or the demerits of the proposed bill in its effect in the general economy

and on ordinary business corporations, we urge that in any event the provisions of the new bill substantially as proposed be retained for mutual investment trusts subject only to modifying section 117.

SECTION 117

Section 117 provides that in the case of a taxpayer other than a corporation, only the following percentages of gain or loss recognized upon the sale or exchange of capital assets can be taken into account for computing net income: 100 percent of the capital which has been held for not more than 1 year, 80 percent if for more than 1 year but less than 2 years, 60 percent if for more than 2 years but not more than 5 years, 40 percent if for more than 5 years but not more than 10 years, 30 percent if for more than 10 years.

Investment trusts, probably more than any other kind of corporations, are vitally concerned with the method of taxing gains, as frequent changes in their portfolios are made which in all cases result in either capital gains or losses. In the case of ordinary business corporations, not considering for the moment investment trusts, insurance companies, and possibly banks, it is reasonable to assume that almost the entire taxable income is derived from ordinary taxable income distinct from capital gains. Therefore, if the words "other than a corporation" are stricken from this section there will be little loss in revenue so far as ordinary business corporations are concerned. Banks and insurance companies are not so much concerned with section 117, as under the proposed bill they are taxed in a special manner different from ordinary business corporations. This leaves investment trusts as the primary class of corporate taxpayer who are concerned with section 117. Under the proposed bill the high tax rates will force investment trusts to distribute at the end of each year all or substantially all of the taxable profits realized on the sale of capital assets. If the shareholders of investment trusts are to be treated as if they were partners who are merely banded together for the purpose of obtaining diversity and expert supervision and use the investment trust merely as a conduit for such a purpose, then in all fairness these shareholders who for the most part are of limited means, should have accorded to them the same relief relative to capital gains as is now provided wealthy individual taxpayers and partnerships. This would be in accordance with the spirit of Mr. Morgenthau's remarks quoted above, and can be accomplished by amending section 117 by striking out the words "other than a corporation." This we advocate. This will diminish the unfair advantage possessed by the wealthy who are able to set up individual trusts managed by private trustees or by banks and which peerform the same function that investment corporations perform for persons of limited means.

OBJECTIONS ANSWERED

It has been pointed out that investment trusts will under the terms of the new bill be forced to distribute to their shareholders all or substantially all of their net taxable income including taxable profits realized on the sale of capital assets and that this procedure is economically unsound for two principal reasons. First, that such distribution in times of prosperity will leave an insufficient amount in the treasury of the trust with which to meet the inevitable losses of periods of depression and, second, that it will give to shareholders, particularly those who are of moderate means and less well informed as to financial matters, an erroneous impression as to the probable recurrence of large dividends, and therefore lead to the dissipation of these dividends rather than the saving of them for expenses during the periods of depression.

We feel so far as investment trusts are concerned that although this is a valid objection it can largely if not entirely be met by taking advantage of section 115. Section 115 provides that whenever a distribution is at the election of any of the shareholders whether exercised before or after the declaration thereof, payable in stock of the corporation or in money, the distribution shall constitute a taxable dividend in the hands of the shareholders regardless of the medium in which paid.

This points the way for investment trusts at the close of each taxable year to declare special dividends out of capital gains which as a matter of policy we presume properly operated investment trusts will clearly designate as declared from such gains rather than from regular income and give the shareholders the right to accept in payment of such special dividends additional shares of the investment trust itself. In our case, at any rate, if this procedure were followed, no load or commission would be charged incidental with the reinvestment of

such capital gains. Indeed, it might be advisable to offer these shares at a discount well below liquidating value. In view of the fact that the shares of such trusts as ours are redeemable at approximately liquidating value at any time, we anticipate that our shareholders generally would exercise their election in favor of taking additional shares instead of cash, and that therefore the uneconomic circumstances above referred to would be dispelled.

To emphasize our suggestions, we therefore urge—

1. That section 117 be amended by striking out the words "other than a corporation."

2. That regardless of whether the partnership theory is adopted for ordinary business corporations generally that in any case it be adopted for mutual investment trusts such as the type of trust represented by the undersigned.

PAUL C. CABOT,
President, State Street Investment Corporation.
MERRILL GRISWOLD,
Chairman of the Board, Massachusetts Investors Trust.

EXHIBIT C

STATE STREET INVESTMENT CORPORATION,
Boston, Mass., May 23, 1936.

DEAR SIR: We recently sent you a memorandum entitled "Suggestions Regarding Treatment of Mutual Investment Trusts and Corporations Under Revenue Bill of 1936, H. R. 12395," also copy of letter under date of May 13 on the same subject.

Briefly, the first of these memoranda pointed out that so far as investment trusts were concerned, the effect of the House bill, provided it were slightly amended by giving the benefits of section 117 to investment corporations and thereby treating them on the same basis as individuals or partners, was fair and equitable and corrected the present situation which heavily penalized individuals of small means who are forced to use investment trust corporations as a conduit for their savings in order to obtain diversification and expert supervision.

Since submitting this memoranda it has, according to press reportes become obvious that the Senate Finance Committee will largely redraft the House bill and is proposing to retain, in fact increase, the corporate levies and add thereto a 7-percent tax on undistributed income of corporations. This, of course, merely aggravates the already unequitable situation as regards the individual of small means and, in the words of President Roosevelt, we feel that "bona fide investment trusts that submit to public regulation and perform the function of permitting small investors to obtain the benefit of diversification of risk, may well be exempted from this tax."

We are therefore submitting herewith two methods which in substance will result in the same effect whereby the original provisions of the House bill will be retained at least so far as investment trust corporations are concerned. It has been pointed out that if the exact partnership theory were applied, there would be almost insuperable difficulties as to method and technique to overcome. In reverting, therefore, to the theory of the House bill for investment corporations, we are maintaining the original principles as laid down by the President in his message to Congress and assure—

1. That investment corporations that do not pay out any of their income will be taxed at rates equal to those under the proposed Senate bill, i. e., 25 percent;

2. That those investment corporations distributing only a part of their income will pay a tax at least equal to the proposed Senate rates and in some instances more;

3. Where an investment trust pays out all its income, including gains, there will be no tax to the corporation as such, but the dividends will be, of course, subject to normal taxes and surtaxes in the hands of the individual recipients.

In other words, the net effect will be a strong incentive for the complete distribution to shareholders of the total income, thereby greatly increasing the taxable income of the individual shareholders. It will, therefore, greatly minimize the ability of rich individuals to evade surtaxes and at the same time will relieve the individual of small means from the unfair burden of taxes that he is today paying through his investment corporation.

You will note that in the specific suggestions the definition of an investment trust is broad and does not limit the category to "mutual investment corporations." Were this deemed to be advisable, we would add the following to the definition as submitted: "*Provided further*, That it shall apply only to corporations each shareholder of which, upon reasonable notice and under reasonable conditions, is entitled to withdraw his share of the corporation property or its equivalent in cash."

State Street Investment Corporation,
By Paul C. Cabot, *President*.

Supplementary Statement Filed by Arthur H. Bunker, May 3, 1940

In testimony given before this committee on April 24, 1940, Dr. Raymond W. Goldsmith and Mr. Lawrence C. Vass of the staff of the Securities and Exchange Commission made certain criticisms and comments upon testimony and supporting statistical studies submitted by me to the committee on April 12, 1940. At the close of the hearings on April 26, I stated that I reaffirmed in all respects the accuracy of the testimony which I had previously given, and I asked and was courteously accorded the privilege of filing for the record a supplementary statement. The following statement is filed pursuant to that permission. It deals not only with the criticisms of Dr. Goldsmith and Mr. Vass but with certain testimony given by Mr. L. M. C. Smith on April 23.

First, as to Dr. Goldsmith's testimony, his remarks had to do primarily with the passage in my testimony of April 12 wherein I cited the apparent discrepancy between the statement—first made before the committee by Judge Healy in his opening remarks on April 2 and subsequently repeated directly and by inference—that "investors have sustained a capital shrinkage of approximately $3,000,000,000 in all types of investment trusts and investment companies," and two passages from House Document No. 70, pages 184 and 187, which I cited, as follows:

"It is, therefore, estimated that the grand total of sales of securities by investment companies of all types from their inception in this country up to the end of 1937 was approximately $7,200,000,000.

"During the years 1927 to 1936, investment trusts and investment companies repurchased or redeemed approximately $1,200,000,000 of their own securities, valued on the basis of cost to the trusts and companies. If these repurchases be deducted from the value of sales of investment company issues which represents total monies contributed by the public to investment companies, then the net public contribution would be approximately $5,300,000,000 during the years 1927 to 1936, and about $6,000,000,000 during the entire existence of these trusts and companies up to the end of 1937."

I then raised the question as to how the alleged shrinkage could have been as large as $3,000,000,000 at a time when the assets of the industry were worth $4,000,000,000.

Now, as a matter of fact, I was entirely correct in raising this question, because at the time when the assets of the industry were worth about $4,000,000,000, namely, at the end of 1936, the total shrinkage was about $1,500,000,000 and not the $3,000,000,000 that is stated by Dr. Goldsmith. The difference between this figure of $1,500,000,000 and the $3,000,000,000, as determined by Dr. Goldsmith, is to be accounted for in a very simple manner. In the first place, Dr. Goldsmith has throughout made the mistake of including $383,000,000 of capital appreciation as "money originally paid by investors to the investment companies for their securities." Therefore, this amount must be used to reduce all losses calculated by Dr. Goldsmith. Further, he has seen fit to discuss the year 1935 instead of 1936, the difference being that the assets of the investment companies were less by $1,070,000,000 at the end of 1935 than they were at the end of 1936. The sum of these figures is almost $1,500,000,000.

Dr. Goldsmith could have thrown some useful light on this problem which seemed a source of constant confusion throughout the hearings. Instead, he concludes: "So, notwithstanding Mr. Bunker's impression, the capital loss is $3,000,000,000.

Now if Dr. Goldsmith were to make a calculation for a period 1 year later—the period to which I was referring—he would have to arrive at the same figure of $1,500,000,000, as I have used exactly the same procedure in

making my calculations as the one used by him and described in his testimony.

Before leaving this subject, it is important to point out that this shrinkage, which Dr. Goldsmith has unhappily designated as "a capital loss," is of course only a "quotational" shrinkage and is sometimes $1,500,000,000, sometimes $3,000,000,000, and that if one could assume that the value of shares will ever return to the 1929 price level the loss would not only cease to exist but would be transformed into a profit to investors in their over-all experience.

It is obvious that whatever the shrinkage may be at any given time, it is due largely to the relation of security prices to the comparatively higher prices existing in the late 1920's.

In view of this, the testimony of Mr. L. M. C. Smith on April 23 is quite surprising, when he stated that at least $1,100,000,000 and possibly as much as $1,500,000,000 of the capital shrinkage in investment companies was attributable to "mismanagement or looting or improper actions of managements in their own interests to the detriment of shareholders."

A careful examination of Mr. Smith's testimony throws no light on how it is possible to reconcile his statements with the facts established above in connection with shrinkage, unless it be, for example, that his figures include many like those given for Corporation Securities Co., of Chicago and Insull Utility Investments, Inc., in the amount of $211,000,000—companies which to our knowledge were not at any time investment companies.

Mr. Lawrence C. Vass, of the statistical staff of the Securities and Exchange Commission, submitted material dealing with several statistical comparisons which accompanied my testimony of April 12. Much of the material filed by Mr. Vass was in the realm of opinion on which men can reasonably differ. However, as to certain statements of Mr. Vass, which were allegedly statements of fact and which bear on my testimony, I feel it necessary to make the following comments.

In discussing some studies with relation to the possible behavior of an actual investment fund in comparison with the Standard Statistics Index of 90 stocks, I reached a conclusion that there was only one practical course by which an investor could even approximately parallel the behavior of the Index. I believed, and still believe, that this was the only course left to the investor, because any other would have required that he employ additional funds. Mr. Vass objects to this premise and offers a substitute completely inappropriate, in my opinion, namely, that the investor use some of his income for this purpose. We, as well as Standard Statistics, had granted the investor the right to keep his net income.

In connection with this problem, I stated, on page 5 of the statistical study which I submitted: "There was only one course left open to an investor, namely, to sell that portion of his rights which netted him such an amount of additional cash to enable him to exercise the remainder of his rights." Now, in the face of this, it seems quite extraordinary that Mr. Vass could have made the following remarks:

"Then we put a mathematician on the job and told him to find out for us the basis which Mr. Bunker must have used to obtain figures so contrary to this study. His answer is very interesting.

" 'Apparently, Mr. Bunker did not follow the correct procedure in making the approximations to the index which were presented to this committee. He apparently decided to make the railroad and utility stocks nearly as important in his fund as the industrial stocks. Now it just happens that utility and railroad stocks fared very poorly over this particular period as compared to the industrial stocks, as can be seen from the figures presented by Mr. Bunker. Any index which exaggerates the influence of railroad and utility stocks will tend to do poorly as compared to the Standard Statistics Index, and this apparently is the reason why Mr. Bunker's approximations show such very poor results from the attempt to invest a fund in the ninety stocks.' "

It seems extraordinary that Mr. Vass should have had to put a mathematician on the job to find out what was the basis of the figures I had submitted, for I had very clearly in my report explained exactly what the basis was. To repeat, the premise upon which I had based my calculations was, in my opinion, the only course left open to an investor, and this course I had very carefully described.

Anyone who wished to find out whether the calculations were correct or not did not have to deal in higher mathematics but only needed to follow the simple course that I had laid out. The easiest method of testing the accuracy of my statements was to have gone to Standard Statistics to find out how many changes were made in the capital structures of the companies in the Index. Whenever one was offered any rights to take up stock, one had to make the calculation as to how many of these rights could be exercised. The

same holds true with regard to other types of capital changes. Nothing else was required except to continue the process throughout the entire period under review.

Mr. Vass apparently did not go to the Standard Statistics, which was the basis of our own investigation. He relied on the work of a mathematician who did not follow the very simple premise I had laid down, and upon manuals which apparently were incomplete in current volumes as to descriptions of the capital changes in the companies which composed the Index. The net result was that through the various deficiencies of the sources used by Mr. Vass he was totally unable to follow the simple premises laid down in my report.

To go further, a great deal of Mr. Vass' testimony seemed to throw doubt upon the fact that there were 333 changes in capital structure during the 14 years which I discussed in my report, or 186 changes over the 6-year period which Mr. Vass preferred to discuss. In passing, it is well to say that these 333 changes or the 186 changes—depending upon which period one wishes to select—were compiled from data obtained directly from the Standard Statistics Co., and in no sense derived either from guesswork or the casual inspection of manuals.

I can deal very briefly with the remainder of Mr. Vass' testimony, which consisted of criticism of two other statistical comparisons which I had used. I had made a study of all issues, other than those of investment companies, which were sold in the year 1929 and traced through their behavior in comparison with the behavior of portfolios of investment companies. This had been done, as I explained, because some 65 percent—according to the S. E. C.'s figures—of all investment-company issues had occurred in the year 1929. It seemed to me, therefore, a very interesting study to find out how the market values of these other issues, including those of some of the greatest American companies, compared in performance with the portfolios of investment companies in subsequent years. Mr. Vass' criticism of my study had to do with the fact that for the performance of investment companies I took the portfolio performance of the 49 investment companies whose portfolio record is available from the S. E. C.'s studies and whose performance had been chosen by the S. E. C. in their own statistical work as typical of the performance of the industry. I then compared this portfolio performance with the market values of non-investment-company issues made in 1929. Mr. Vass is critical of my use of the 49 companies and of the fact that I compared portfolio values with market values. With respect to the latter criticism, I can only say that this method of comparison is that which was established by the S. E. C.'s statistical studies and not by me.

Mr. Vass' further criticism was that I used as a basis of comparison the 49 companies which in his testimony of April 24 he described as "49 hand-picked companies" and "49 best companies in the country." This description of the 49 companies in Mr. Vass' testimony before the committee was a distinct surprise to me, since throughout the hundreds of pages of statistical reports of the S. E. C. from which my figures were derived there was no intimation whatever that the 49 companies which the S. E. C. had chosen were "hand-picked" or "the best." In fact, the method of choosing these companies was clearly set forth as follows in House Document No. 70, Appendix J, pages 839 and 840:

"The analysis includes virtually all companies satisfying these * * * conditions, companies being eliminated only because of insufficient data or because of the presence of extremely large bank debt. In order to obtain exactly the same group for analysis each year, companies for which data were unsatisfactory for 1 or more years during the 1930–35 period were entirely excluded. (Footnote 36: Only a few companies were excluded for this reason.) After these exclusions, a group of 49 companies remained."

Indeed, the chapter of House Document No. 70 which covers the performance record of closed-end companies and which starts on page 842 of that document completely confirms the propriety of my use of the 49-company average since it is entitled "The performance of the typical company."

The final criticism by Mr. Vass has to do with my use of a comparison of the performance of a list of 50 stocks recommended for investment by a leading investment rating service on September 30, 1929, with the average performance of investment companies over the subsequent years. Mr. Vass finds fault with the composition of this list inferentially suggesting that I chose it because it contained an undue proportion of utility stocks and railroad stocks which later performed badly marketwise. My studies showed that the average investment-

trust performance was some 44 percent better over the next 6 years than that of this list of recommended stocks. I may say that this list was chosen because it was the only such list available as of this date which would constitute a thoroughly unbiased and sophisticated investment recommendation made by a disinterested and competent agency. The list was a highly professional investment recommendation; the purpose of citing it—or indeed citing any list—was simply to illustrate the fallacy of the S. E. C.'s contention that an unmanaged portfolio of stocks purchased in 1929 would have done better than the portfolio of the average investment company. The S. E. C. in endeavoring to prove this premise chose to use a list of stocks contained in the Standard Statistics Index, the impracticability of which use I had shown at some length. It is my opinion that any list of stocks actually recommended for investment purchase in 1929, and having regard to the classes of securities which were regarded as the best investment media at that particular time, would have shown a performance record very similar to the one shown by the list which I chose.

STATEMENT BY MAHLON E. TRAYLOR, PRESIDENT OF MASSACHUSETTS DISTRIBUTORS, INC., FOR THE RECORD OF THE HEARINGS OF THE SUBCOMMITTEE OF THE COMMITTEE ON BANKING AND CURRENCY OF THE UNITED STATES SENATE

My name is Mahlon E. Traylor. I am president of Massachusetts Distributors, Inc., underwriter or general distributor of shares of Massachusetts Investors Trust, Supervised Shares, Inc., and Boston Fund, all open-end companies—i. e., having redeemable shares. This is my second statement on the subject of pricing, selling, and repurchasing shares of open-end investment companies. It is offered in support of my previous testimony, and in rebuttal to the testimony of Mr. Bane of the Registration Division of the Securities and Exchange Commission on this subject.

Judge Healy remarked near the close of the hearings that he failed to understand why I should come down to Washington, after making suggestions to the Securities and Exchange Commission in February 1940 as to how certain problems in connection with the pricing and selling of shares of open-end companies could be handled and after indicating a willingness that the Securities and Exchange Commission be given authority to regulate this phase of the open-end business and oppose such a plan and ask that instead the regulation of this phase of the business be undertaken by the National Association of Securities Dealers, operating under the Maloney Act. I would like to answer Judge Healy by asking him to review my testimony of April 17 in light of the statement contained in these pages, for I believe that in doing so he will find that I have made my position quite clear.

At the outset I wish to summarize my objections to a few points in Mr. Bane's testimony upon which it seemed to me he laid the greatest stress:

(1) The leading example of the "dilution" experienced by one particular company on September 5, 1939, is not a fair sample.

(2) The computation of annual "dilution," based on the experience of September 11 and 19, 1939, assumes a rise in the market during a single year which is fantastic.

(3) The picture of the "evils" of the two-price system is very much overdrawn and also fails to give fair credit to the industry for the progress already made in improving its methods and practices.

(4) The contention that shares are sold by investment companies only at the end of the day when the next day's price is already known is extremely misleading in that it rests entirely on the technicality of a mechanical clearing of sales at the close of business and ignores the business reality that shares are sold to investors throughout the day.

(5) The inferences from an extract read from a supplemental booklet describing Massachusetts Investors Trust is grossly misleading, and the entire testimony regarding this matter is wholly unjustified.

Mr. Bane quoted from my earlier testimony in which I said that he (Mr. Bane) "cited the example of the shares of an open-end company which on September 5 advanced in price from $5.60 to $6.70 and yet were sold to the public on the basis of a value of $5.60 even though their established and known value was $6.70 according to the Securities and Exchange Commission testimony.

"It is upon this illustration that the Security and Exchange Commission's case in the matter of so-called 'dilution' was very largely based. With all possible emphasis, I should like to say that this illustration is completely irrelevant as

far as 90 percent or more of the open-end industry is concerned. It is also probably the most extravagant example the Securities and Exchange Commission could have used. To employ Mr. Bunker's well-conceived analogy, this is most certainly a specimen and an exceedingly rare one at that, rather than a run-of-the-mine sample."

Mr. Bane then said in his testimony, "I want to emphasize to this committee that that example was in no sense a specimen, but it was a fair sample." To back up this emphatic statement, Mr. Bane's only supporting argument was that the price of the shares of the company used in his example advanced only $1.10 on September 5, 1939, whereas in the case of Massachusetts Investors Trust the advance was $1.22, and in the case of Boston Fund, Inc., the advance was $1.50.

In the first place, the $1.50 figure for Boston Fund is inaccurate; the correct figure is $1.21. In the second place, the illustration as given is meaningless because the $1.10 advance relates to a price of $5.60. (This is the most extreme percentage advance, excepting one, of the entire 78 companies.) In the case of Massachusetts Investors Trust the advance of $1.22 relates to a price of $19.68; and in the case of Boston Fund the advance of $1.21 relates to a price of $14.54. The average price advance for these two companies is some 7 percent (about the average for the industry) against 19.6 percent in Mr. Bane's example.

Now I submit the following facts so that the committee may judge for itself whether the example, upon which the Securities and Exchange Commission's case in the matter of so-called "dilution" was very largely based, is a specimen and an exceedingly rare one at that or whether it is a fair sample as Mr. Bane would have you believe:

(1) More than 90 percent of the assets of the open-end industry are those of companies whose investments are, on the average, diversified among some 40 to 60 individual stocks representing 15 or 20 different industries. They have what is known as a cross-section diversified portfolio of investments.

The company which Mr. Bane used in his example is a small specialty company whose entire investment portfolio consists of common stock holdings in seven steel companies.

(2) It will be recalled that September 5, 1939, witnessed a "war market" unprecedented in the history of the open-end industry. Steel stocks are perhaps the most volatile of all "war babies," and the sole investments of the company used in Mr. Bane's example consisted of holdings in seven steel stocks.

(3) Total assets of the diversified cross-section type of company are over $500,000,000.

Total assets of the specialty type of company used in Mr. Bane's example account for about 3½ percent of the industry total, and only a small proportion of the companies making up this percentage of the total is of such a volatile nature as the company in question.

(4) The average increase in the value of the assets of the industry on September 5, 1939, as a result of the market advance was in the neighborhood of 7 or 8 percent.

The increase in the value of the assets of the company used in Mr. Bane's example was 19.6 percent. Of the entire 78 companies to which reference is made, only one experienced an increase in the value of its assets of more than 19.6 percent. That company was another specialty company, the investments of which consist entirely of common-stock holdings in 12 railroad equipment companies. In that instance, the increase amounted to about 20 percent.

(5) The amount of so-called "dilution" of shareholders' interests for the industry on the abnormal and unprecedented occasion of September 5, 1939, was, as I have previously stated, approximately three-tenths of 1 percent.

According to Mr. Bane's testimony, the company used in his example experienced a "dilution" of shareholders' interests of 9.86 percent, or more than 30 times the percentage amount of so-called "dilution" for the industry as a whole.

I said the example was completely irrelevant with respect to 90 percent of the industry and that it was probably the most extravagant example the Securities and Exchange Commission could have used. I called it a "specimen" and an exceedingly rare one at that. Replying to my testimony, Mr. Bane said he wanted to emphasize to the committee that the example was in no sense a specimen but that it was a fair sample.

In my previous testimony, I sought to avoid any such discussion of other people's business for reasons which can be readily appreciated. I did not attempt to defend or justify what occurred in this isolated instance. The problem involved is one which is well recognized in the industry, and it is believed to be one which the industry can solve. Moreover, as I have indicated

elsewhere, steps have already been taken to find satisfactory solutions to problems such as this. And may I remind you that the problem became acute only as a result of the abnormal unprecedented war market on September 5, 1939.

When I testified before the committee, I merely endeavored to discuss the matter of so-called "dilution" in a practical and realistic manner as it affects nine-tenths of the industry. I did this in such detail because Mr. Bane's initial testimony on the subject, through the use of rare and extreme examples and in emphasizing large dollar amounts of "dilution" without showing these amounts in their proper perspective by relating them to the value of the affected shareholders' interests, seemed to me to create an erroneous and misleading impression of the seriousness of the matter.

The second point in Mr. Bane's testimony on which it seemed to me he laid great stress has to do with my testimony concerning the so-called "dilution" which, according to Mr. Bane's assertion, took place on September 11 and 19, 1939.

Now Mr. Bane took exception to my corrected statement that the "dilution" on these 2 days, September 11 and 19, amounted to thirty-five one thousandths of 1 percent. (You will recall that Mr. Bane represented to the committee that no one could contend that there was anything abnormal about those 2 days—despite the fact, as I pointed out, that excepting the war market on September 5, there was only one day during the entire year 1939 and 1940 to date when the stock market advanced more than it did on either of those days.) My figure of thirty-five one thousandths of 1 percent was computed on the basis of affected shareholders' interests being some $500,000,000, whereas Mr. Bane says the amount was only $408,000,000 because all the companies did not sell shares on the 2 days in question, and on that basis the "dilution" figure comes to forty-three one thousandths of 1 percent. I am unable to reconcile this basis of figuring to my own calculations, but I will nevertheless accept Mr. Bane's figure. In that way I am able to say, on the authority of the Securities and Exchange Commission, that the so-called "dilution" of affected shareholders' interests on those 2 exceptional days of September 11 and 19, 1939, was forty-three one thousandths of 1 percent. I would like to repeat that: the Securities and Exchange Commission says in effect that on 2 days when the market staged its sharpest advances excepting two in a period of a year and a quarter, the "dilution" of affected shareholders' interests was forty-three one thousandths of 1 percent.

Now we come to what seems to me to be one of the most remarkable bits of testimony that has been presented to this committee. I said that for the 2 days, September 11 and 19, the so-called "dilution" on the Securities and Exchange Commission's basis of figuring was thirty-five one thousandths of 1 percent. (As indicated above, I will accept the correction, making it forty-three one thousandths of 1 percent, but on this particular point I must stick to the thirty-five one thousandths of 1 percent figure because that is the figure from which Mr. Bane built his remarkable testimony.)

I said further—and I grant that my language may be somewhat ambiguous and therefore subject to misinterpretation—that on an annual basis this would come to five one-hundredths of 1 percent—and if doubled to take care of a few semiabnormal days (as distinguished from such abnormal days as September 11 and 19) it would come to ten one-hundredths of 1 percent—and if tripled to take care of a few more, it would come to fifteen one-hundredths of 1 percent.

That all made fair sense to me when I offered it in testimony and it still does, and I will explain why. But first let me dwell briefly on Mr. Bane's astounding testimony. He said that I assumed 300 business days in a year; so I multiplied the "dilution" figure on the 2 extraordinary days of September 11 and 19 by 150 to obtain an annual "dilution" figure. Then Mr. Bane said that because my arithmetic was bad and his was good, the annual "dilution" figure was 5.25 percent or $26,400,000, and that, following my example, if doubled to take care of a few semiabnormal days, it would be 10.56 percent or $52,800,000, dan if tripled to take care of a few more, it would be 15.84 percent, or $79,200,000.

Anything as remarkable as this, however, would seem to call for rather careful analysis. This I have attempted to undertake, and these are my findings: If we multiply 2 days' "dilution" by 150 to arrive at an annual figure, we must (in order to visualize the circumstances under which is "dilution" might take place) multiple the number of points which the stock market advanced on these 2 days by 150. In other words, if we are to project the "dilution" for 2 days on an annual basis, we must to be consistent also project the corresponding advance in the stock market on an annual basis. Well, the advance for those 2 days, September 11 and 19, 1939, amounted to 8½ points in the Dow-Jones

Average of 30 Industrial Stocks. On an annual basis then, to be consistent with Mr. Bane's "dilution" figure, the Dow-Jones Average would have to advance 4¼ points every day, or 1,275 points during a year of 300 business days. Thus the only basis on which any possible validity could be attached to Mr. Bane's "annual dilution" figure is to have the stock market, as measured by the Dow-Jones Average, advance 1,275 points a year.

Of course, that makes the whole idea very farfetched, particularly when you consider that since the low of the depression in 1932, this Average has managed to register a net advance of only about 100 points, and in the greatest bull market in history it took about 10 years to register a net advance of some 300 points to the all-time peak of 381 in September 1929.

As to my own figures, I simply tried to indicate in a general way a reasonable estimate of what the so-called dilution might come to in the course of a year which would include two such abnormal days as September 11 and 19 and a few more semi-abnormal days for good measure. I first gave recognition to the fact that September 11 and 19, 1939, were abnormal days. Then I estimated on the basis of available statistics on sales volume and normal market advances over a year's time what the theoretical dilution might be. This came to about five one-hundredths of 1 percent. Then, on allowing for the semi-abnormal days, the figure came to about ten one-hundredths of 1 percent—and then for good measure I increased it again to arrive at a final figure of fifteen one-hundredths of 1 percent which, as I remarked earlier, seemed to make fair sense when I offered it in testimony, and I still think it does. (I am attaching as exhibit A an explanation of the basis of my own figuring. This may be placed in the record or not, in accordance with the committee's wishes in the matter.)

There is one other point on which Mr. Bane placed great stress. This has to do generally with what he calls the evils of the two-price system. His lengthy testimony on this subject is too confusing to a proper understanding of the matter and so overdrawn in its implications that I shall not even attempt to answer it point by point. At the beginning of my previous testimony I said I believed that there is a widespread misconception of what the problems really are and how the pricing system actually works. I can only ask that my previous testimony on the subject, on which I stand without qualification, be reviewed in the same spirit of carefully considered reasoning in which it was given.

In the case of Massachusetts Investors Trust—and we seem to be the ones who are being criticized, the offering of shares was withdrawn at 4 o'clock in the afternoon of September 5 when the new price was established and orders received after that time were confirmed at the new higher price so that in our case there were not two known and established prices at the time sales were being made. We took this step in accordance with a policy which we had adopted a year and a half earlier as a means of meeting just such a situation as developed on September 5, 1939, and which was outlined in a letter to our dealers, dated April 4, 1938. Contrary to Mr. Bane's understanding as expressed in his testimony, September 5, 1939, was the fourth occasion, not the only occasion, on which we stopped selling when the market registered a sharp advance.

Incidentally, it was from a two-page enclosure with this letter outlining the method for handling transactions in Massachusetts Investors Trust that Mr. Bane quoted two short paragraphs in such a way as might leave a misleading impression. I will discuss this later, but with reference to the point under consideration, I want to quote from our dealer letter of April 4, 1938 as follows:

"The fluctuations of the stock market during recent weeks have caused us to give further thought to the problem of accepting orders for shares of Massachusetts Investors Trust in the event of an extreme rise in prices. The enclosed 'Approved Practices for Transaction of Business in Shares of Massachusetts Investors Trust,' copy of which has already been sent to you, states in the third paragraph that 'in the event of extreme fluctuations in security prices, we may consider it necessary at some future date to decline to accept orders for shares on the present basis of pricing until an offering price reflecting a new liquidating value may be established.'

"Rather than leave the question of whether or not we will accept orders on any given day in suspense, we feel that for the convenience of dealers it is desirable to establish a rule of procedure on this question. Therefore, until further notice, in the event the Dow-Jones Average of 30 Industrial Stocks should make a net advance for the day of $5 or more, no orders for shares of

Massachusetts Investors Trust will be accepted by us at the old offering price after 4 p. m. Boston time on weekdays, or 1 p. m. Boston time on Saturdays.

"At present a new offering price reflecting any change in the 'liquidating value' is established 1 hour after the close of trading on the New York Stock Exchange each day. This new offering price, however, does not become effective until 10 a. m. Boston time the following business day. In the event of an advance of $5 or more in the Dow-Jones average of 30 industrial stocks, all orders received after the determination of the new price at 4 p. m. Boston time weekdays and 1 p. m. Boston time Saturdays will be held and confirmed when the new or higher price becomes effective at 10 a. m. Boston time on the following business day."

I want to emphasize that our contribution to the adoption of constructive policies with respect to the pricing system did not consist of writing letters to the Securities and Exchange Commission, suggesting various ways by which it might be advisable "to lock the barn after the horse was stolen." On the contrary, we wrote letters to dealers, advising them of the adoption of what we believed to be constructive policies in the interests of sound business practice. And we did this despite the fact that Massachusetts Investors Trust was less affected by dilution than the industry as a whole—as witness the infinitesimal dilution figures which I have submitted in previous testimony.

With further reference to Mr. Bane's discussion of the evils of the two-price system, let me try to restate briefly what the situation has been.

In past years, the existence of two known prices was only an incidental result of the mechanics employed to insure a firm price at which shares could be offered for sale. No serious problems developed and under the conditions which prevailed there was seldom even opportunity for abuse. As far as the two-price system being used as a principal selling argument in the sale of cross-section open-end companies, I stand without qualification on my previous testimony and that of my associate, Mr. Sanders.

In that testimony I did not attempt to defend any evils, nor do I now. I merely tried to present realistically in light of many years' experience what the situation had been, Mr. Bane's testimony notwithstanding. To simplify my exposition, I discussed the two aspects of the matter separately. One aspect concerns the so-called dilution that might occur from the mechanical operation of the pricing system—that is, the sale of shares at a fixed price which does not necessarily reflect the theoretical value of the shares at the exact moment of sale. I showed that the effects of any resulting dilution of shareholders' interests, taking the industry as a whole, were negligible, although I was not unmindful that in isolated cases the effects could be more serious.

The other aspect concerns the abuses by way of riskless trading, etc., by distributors, dealers, and insiders which the pricing system made possible. In many respects, such opportunities for abuse are similar to the opportunities for the free riding abuses which have existed in connection with the issuance of Government bonds. I explained that it was the abuses of the pricing system which a small fringe element may have practiced to unethically further their own selfish ends and that while relatively unimportnat, though nonetheless deplorable, they could be eliminated entirely by the imposition of a few simple rules. An outline of such rules was contained in our letter to Mr. Lund of the Registration Division which Mr. Bane read into the record of this hearing. These rules represent the basis on which my company has successfully met the problems which have come up. As evidence of the manner in which we have successfully met these problems, let me cite the experience of my company on September 5, 1939—and this was before the Securities and Exchange Commission had ever indicated any serious interest in the matter.

An analysis of that day's transactions, as compiled by the State Street Trust Co. acting independently as transfer agent for Massachusetts Investors Trust and Boston Fund, revealed the following: Out of a total of 139,975 shares of Massachusetts Investors Trust sold on September 5, 1939, only 90 of these shares were redeemed on the following day (September 6) at the new higher price and only 228 of these shares were redeemed on the day after that; out of a total of 40,952 shares of Boston Fund sold on September 5, 1939, 125 of these shares were redeemed on the following day (September 6) and none were redeemed on the day after that.

With respect to "riskless trading" by insiders, I wish to make it clear that as far as our operations are concerned—and I believe this is typical of most important companies—no such practice has ever been condoned, and the official offering prospectuses of the investment funds we sponsor clearly state that officers, directors, and employees of the investment funds and of the general

distributor are permitted to purchase shares only for personal investment so that no trading in the shares could be undertaken in any event. Incidentally, on the occasion of the extreme price rise of September 5, 1939, no such person described above took advantage of the price rise that day to buy any shares of any of our three companies. It may be of interest in passing that officers, directors, and employees and their families have an aggregate investment in shares of the funds under our sponsorship of more than one-half million dollars.

I have described in this and previous testimony the situation in past years. September 5, 1939, indicated the need for further refinements in the pricing system and since that time many of the important companies in the industry have taken steps to improve their methods in light of the experience gained on that day. In the case of Massachusetts Investors Trust, a new pricing system was adopted, effective January 2, 1940. Under this system, shares are priced twice during each day excepting Saturdays. One price is established on the basis of closing market prices and remains in effect only until a new price is established at 1 o'clock the following day. The price established at that time holds good until the next price is established after the close of the market that day. At no time are there two known prices in existence at the same time. And by pricing the shares both in the middle of the day and at the close, the price at which shares are sold reflects as closely as is possible and at the same time practical the value of the shares at the time purchase orders are taken. We believe this pricing system minimizes the opportunity for abuse and with the imposition of a few simple rules, any such opportunities can be completely eliminated. Moreover, we believe that it will effectively serve to reduce possible dilution to a practical and negligible minimum—at least in the type of company such as Massachusetts Investors Trust.

One last point on this subject—Mr. Bane said that he believed the committee had received an entirely erroneous and misleading impression from Mr. Sanders' and my testimony to the effect that shares of open-end companies are sold all during a business day. "The cold fact is," he said, "that the trust makes sales in practically all cases at one time only during the day to the distributor, and that time is always after the two prices have been determined and are known." The absurdity of introducing this technical point was suggested by the confusion it seemed to create in the minds of those who heard the testimony. Obviously, the trust or investment company does not sell shares to investors throughout the business day. As a matter of practical convenience, the underwriter clears with the trust but once a day (or twice a day in the case of Massachusetts Investors Trust which establishes a new price twice a day). Regardless of the mechanical technicalities, however, the fact remains that shares are sold to investors all during the day and, contrary to Mr. Bane's flat assertion, dealers send orders received in to the distributor all during the day. For example (and as a conservative estimate) I would say that a third of our volume came in by 12 o'clock noon on September 5 last.

By introducing this technicality, Mr. Bane seems to imply that the trust or investment company remains entirely in ignorance of the volume of sales until the close of business, and therefore no opportunity exists to offset the sale of additional shares by the purchase of portfolio investments at a market level reflecting the price at which shares are sold.

In my previous testimony, I explained that while actual cash from the sale of new shares may not come in during the day, execution of orders amounts to the same thing from a bookkeeping standpoint. The simple commonsense point is that the management of the investment company is vitally concerned with the volume of sales during the day because of management-policy considerations, and I can assure you they make it their business to know just as much as the distributor does about the volume of sales during the day. In fact, in most cases the distributor and the issuer are in effect one and the same and it is hardly reasonable to assume that one hand doesn't know what the other one is doing.

The facts are, as I have stated, that sales are made during the day—dealers do report sales during the day—and trust managements do know the trend and volume of sales during the day and they are therefore in a position to do whatever seems advisable by way of offsetting the sale of shares by additional portfolio investments, regardless of the mechanical technicalities involved in the clearing of business.

I wish now to dwell just briefly on some of the other points in Mr. Bane's testimony. In his entire testimony, there is but one point with which I fully agree. That is where Mr. Bane says the extent of "dilution" is a matter of degree. That is one of the principal things I have been trying to impress upon

the Committee. I have, therefore, taken pains to prove that the degree is of negligible proportions for the bulk of the industry and that with further improvements now being adopted, the degree can be reduced to a practical and negligible minimum.

Now Mr. Bane made quite a point of the fact that sales of Massachusetts Investors Trust on September 5, 1939, were some 92 times the average daily sales during the year. I would like to remind the committee that, as Mr. Sanders told you, we go through long periods of dullness—sometimes for months when because of uncertainties and fears, investors are hesitant to act. This has been particularly true in the last year or so, and of course the occasion of the war market of September 5 was unprecedented in the history of our business.

Let me illustrate the exaggerated implications of Mr. Bane's statement. Assume that a housewife buys 1 pound of sugar a week, or 52 pounds a year. On a daily basis, this amounts to about one-seventh of a pound. Along comes the outbreak of war in Europe and, wisely or foolishly, like many other housewives she calls up the grocer and buys 15 pounds. That is over 100 times her theoretical daily purchase, but certainly that is no reflection on how the grocer conducts his business. But disregarding the war influences, the implications are still highly exaggerated. Owing to circumstances over which we have neither control nor influence, we do no business to speak of on probably half of the business days in a year such as 1939 and there is nothing the S. E. C. or anyone else can do to alter that situation. For this reason, any comparison of any one day's actual sales to a purely hypothetical "average daily sales volume" lacks any significant meaning.

I have shown the extent to which so-called "dilution" affected the interests of Massachusetts Investors Trust shareholders, and I might add the effects with respect to Supervised Shares, Inc., were even more negligible, if that is conceivable. But Mr. Bane has also made reference to Boston Fund, Inc. I have explained in detail in earlier testimony why I believe Mr. Bane's hypothetical conclusions concerning "dilution" to be invalid. Let me give you a concrete example using Boston Fund: From Mr. Bane's testimony, you might be led to believe that the interests of shareholders of Boston Fund had been seriously "diluted" during the month of September 1939 because of all the thousands of shares of the Fund which were sold during the month "at less than their true value."

Now bearing in mind what have said about the invalidity of Mr. Bane's hypothetical conclusions, here is how the existing shareholders of the fund fared during that month. With apologies to Mr. Bunker, the Standard Statistics' 90 Stock Index advanced 16.4 percent during the month of September. (You may recall from S. E. C. testimony, this market average is supposed to reflect the performance of a diversified cross-section of representative stocks like a fully invested fund but with no new money coming in and no management problems.) I would also like to point out that this advance is for the short period of one month in a sharply rising market. As I have said, this market average advanced 16.4 percent. During the same period, the value of shares of Boston Fund increased 17.2 percent.

I do not know what conclusions Mr. Bane will draw from this, but my own conclusion is that perhaps his testimony has tended to exaggerate the seriousness of the so-called "dilution" problem. I might add that my conclusions are not based merely upon a set of statistics. I have a deep personal concern for the interests of shareholders as, among other reasons, I have been the largest shareholder in the company for several years, owning some 10,000 shares with a market value of around $160,000.

Mr. Bane's quotation (to which I have previously referred) from an instruction sheet enclosed with a letter to our dealers, dated April 4, 1938, covered in matter-of-fact language an incidental phase of business routine. In order to avoid misunderstandings between our company and the dealer, and between the dealer and his customer, we had developed an instruction sheet outlining how orders were to be placed, including conditional orders, and at what price under various circumstances orders would be executed. The fact that our procedure assured executions at the best price is certainly no reflection upon that procedure. There might, however, have been some reason to complain if we had issued no explicit instructions and then confirmed orders on a price basis favorable to ourselves as was the case in one example cited by Mr. Bane by which he sought to indicate how unethically certain people in the industry operated.

Mr. Bane also quoted from a letter I wrote to him on December 28, 1939, in which I advised him of the new pricing system which was to be adopted by Massachusetts Investors Trust on January 2, 1940. This is the pricing system which I have previously described whereby a new price is established in the middle of the day and again at the close of the market, only one price being know and established at a given time. Mr. Bane testified that in this letter I indicated that the steps which we and others in the industry were taking at about this time did not go far enough to solve the problem. That is incorrect. After calling Mr. Bane's attention to an enclosure which explained our new pricing system, I remarked that others in the industry were also making changes, saying, "* * * I have already heard of a number of the distributors who are taking definite steps to stop selling before the new price becomes known in the afternoon, which is a step in the right direction, but, in our judgment, does not go far enough * * *."

Mr. Bane, in introducing in the testimony our letter to dealers describing the operation of the pricing system adopted January 2, 1940, said that he "was surprised at the type of person to whom (it) is addressed in view of the claim that this (Massachusetts Investors Trust) is an investment trust." "This is headed," he read, "Important Notice to Salesmanagers and Traders." I can only assume that Mr. Bane believes that "traders" are the speculators "who trade in and out of trust shares at the expense of the trust" and that we were catering especially to such persons.

Well, in the hundreds of dealer offices with which we do business, the "trader" is the particular employee who executes salesmen's orders, and in executing orders in our trust shares he is bound by a contract between his company and ours to execute such orders at the official prices, the basis for the determination of which is set forth in the prospectuses. It is, therefore, quite essential that "traders" be fully informed concerning any change in the method of pricing shares.

As to "salesmanagers," we know of no one, apart from "traders," to whom such a notice could more appropriately be sent. Salesmanagers are in charge of the salesmen who sell the shares, and it seems to me rather important that they should be well informed concerning the pricing procedure which they are obliged by contract to observe.

Now, with respect to my "most unrealistic" testimony as to how sales of open-end companies are effected, I stand, without qualification, on every word of that testimony. But I would like to cite, as an example of the character of Mr. Bane's rebuttal testimony, the only concrete argument he advanced to discredit my statements. He said: "The story given you by witnesses from the industry of how sales are effected was most unrealistic. To compare the pricing and sale methods and the effects thereof of these trusts with the sale of Treasury bonds is illustrative of the sales ideas and arguments of these investment-trust salesmen. The statement made by Mr. Traylor respecting dilution arising from the sale of Government bonds in the light of my experience seems incredible. I have never heard of an occasion when Government bonds were being sold by the Government for a period of 19 hours at two different prices, affording the purchaser an opportunity to purchase at the lower of the two prices."

First, I made no statement "respecting dilution arising from the sale of Government bonds." I did say that Government bonds are sold on a firm price basis and that it is long-established and accepted practice for the Treasury to price a new issue in relation to its outstanding obligations so that the new issue will immediately sell at a premium. Second, it should be apparent to Mr. Bane from my previous testimony that whether or not he ever heard of it, so-called baby bonds are sold, not just for a period of 19 hours, but for 24 hours a day—day in and day out, month in and month out, and year in and year out—to the extent of around a billion dollars a year at a firm price which is considerably below the known price at which other Government bonds are selling. For example, and this was furnished me by a competent independent authority on Government bonds, while it is difficult to make a comparison between a discount obligation and a coupon obligation, United States Treasury 2½'s due September 15, 1948, recently sold at 107²⁰⁄₃₂ to yield 1.55 to maturity in 8 year and 7 months. A baby bond with 8½ to 9 years to run to maturity yields 2.67 percent. An 8½-year 2½-percent Treasury bond on a 2.67 percent basis would sell at 98²⁰⁄₃₂, a difference of 9 points.

And that's not a war-market situation but something that exists every day of the year. This independent authority also advises me that on the regular quarterly offerings of Treasury bonds, the order books are left open for 15 hours after the price of the new issue has been announced, and during a time while

other Treasury bonds of the same character may be selling at relatively higher prices in the open market. This authority adds that the Treasury endeavors to price a new issue in relation to its outstanding obligations so that the new issue will immediately sell at a premium. I wish to imply no criticism of the Treasury's methods. I am quite satisfied that they are operating in the best interests of both taxpayers and investors, and I am willing to concede that they know more about what they are doing than I do. It does seem quite obvious, however, that, as I previously said, they recognize the necessity for a firm price in selling their bonds.

And I might repeat from my earlier testimony that in the case of open-end funds there is no conscious effort to "price the shares favorably in relation to the general market." In fact, the only thing that is desired in connection with the pricing of shares of open-end companies is to establish a firm price as closely in line with the actual value as is practically possible.

I now come to my final point, and it is a most important one. Mr. Bane quoted an excerpt from Mr. Bunker's testimony to the effect that if salesmen of investment-company securities attempt to confuse investment companies with savings banks, they are guilty of gross fraud and should be dealt with accordingly. Then Mr. Bane said, "Let me read to you an extract from an illustrated booklet entitled 'Massachusetts Investors Trust, History, and General Information.'" He then read the extract which goes as follows: "Massachusetts Investors Trust is a mutual trust. It is operated on a basis similar to a mutual savings bank. Like a savings bank, it depends for its future welfare and continued success upon public confidence."

That would seem to indicate that we are being accused of gross fraud.

But, as Senator Wagner frequently remarked during the hearings, you want to hear both sides. Let me tell you a little about this booklet. It was the first descriptive booklet issued by Massachusetts Distributors, Inc., after I became president of the company. Looking back, I am rather proud of it for its complete frankness and for the detailed information which it contains. Incidentally, this booklet, published in February 1935, was replaced by a revised edition in February of the next year.

Here is what I want to tell you about the booklet. It contains 31 pages in all, and the extract quoted above appeared on page 28 in a chapter headed "Other Important Features" under one of five subheadings. The particular subheading under which the statement appears reads "Operating Costs." Now quite contrary to the misleading impression given in Mr. Bane's presentation of his testimony, there was not the slightest intent to confuse Massachusetts Investors Trust with a savings bank. After having devoted 27 pages to a detailed explanation of what Massachusetts Investors Trust is—how it operates—and the manner in which its shareholders participate in the trust, we made a perfectly fair and honest statement that with respect to operating costs, the trust is operated on a basis similar to a savings bank and that like such a bank the trust depends for its future welfare and continued success on public confidence. We went on to say, "One factor which has an important bearing on this point (public confidence) is whether or not the trust's operating expenses are out of proportion to the services performed." We then presented a table showing what the annual rate of expenses were, and we didn't use percentages. We showed in round-dollar amounts what it would cost a shareholder per year on the basis of a $1,000 investment and on a $5,000 investment, and on ten and fifteen and twenty and twenty-five and fifty and one hundred thousand dollar investments. Then we invited comparison of these costs with what the services performed by the trust would cost if udertaken independently, and we suggested such items as "collection and accounting of income from a diversified list of holdings, reconciling income from many sources for income tax and other purposes, statistical and research services, dependable investment advice, and time and effort necessary to proper supervision of investments."

To put this discussion of operating costs in its proper setting, I think it would be revealing if I quoted a few extracts from other parts of the booklet.

On the first page of text, the first two paragraphs read as follows:

"Massachusetts Investors Trust is not a new development. Although it embodies investment policies which have received more general recognition of late, it has been applying these policies for more than 10 years. Before the advantages of common-stock investing were very generally appreciated and before the necessity for specialized administration in this field became apparent to the rank and file of investors in this country, Massachusetts Investors Trust was functioning on a principle which gave recognition to these advantages,

and the need for specialization in obtaining them. It is, moreover, the principle which governs the trust's activities today.

"That principle is to provide investors, through honest and competent management, with a continuing investment program which meets the requirements of sound practice in common-stock investing. These requirements, fundamentally, are: (1) Diversification which introduces the law of averages in protection of principal; (2) reasonable return on invested capital; (3) opportunity for appreciation of principal; (4) high degree of marketability."

And from the third paragraph on that page—

"The trust was organized under an Agreement and Declaration of Trust * * *. Investors in this fund hold certificates of beneficial interest in a trust managed by trustees * * *. In effect, shareholders become participants in a living trust."

On page 9 there appears a chart which shows the net change in the value of the shares from the date of original offering in 1924 to the end of 1934. This chart shows that the value of the shares at the end of the period was 85 percent of their original value in 1924. It also shows that the preservation of the principal value of the shares at this reduced value was some 30 percent better than the preservation of values as represented by the general level of stock prices for the 10-year period.

On page 11 there appears a line chart picturing the fluctuations in the value of the shares over a period of 1 year. This chart shows that the value of the shares can go down as well as up.

Following that is a discussion of the record of dividend payments, which includes a chart showing the decline in the income from a hypothetical investment in 1929 when income on such investment would have amounted to $6,500 to the income on the same investment for the depression year 1932 when the income would have amounted to $3,230. There is also a discussion of how the trust operates, and a review of management policies which includes these statements:

"Before leaving this discussion of portfolio changes, it should be a matter of record that * * * the management of Massachusetts Investors Trust misjudged both the severity and extent of the depression.

"Instead of converting a large proportion of common-stock holdings into cash or its equivalent early in the depression, it concentrated investments in those companies and industries which seemed best able to withstand the depression * * *.

"This policy, however, failed to produce the full measure of advantage which the management felt justified in expecting * * *. It did, however, have the positive effect of conserving income, which made it possible for regular quarterly distributions to be maintained throughout the depression at a rate which compensated to some extent for the temporary shrinkage of principal."

On pages 21 and 22 there is given a detailed schedule of every change in the portfolio of the trust's investments during the year 1934. On the following page is a table showing a complete list of investments of the trust as at the end of 1934, with the dollar amount invested in each security on the basis of a $100,000 interest in the trust. Other sections discuss in detail the investment policy, the dividend policy, and the operating procedure.

Under the subheading "Marketability" on page 30, there appears the following statement:

"Shares in Massachusetts Investors Trust represent participation in an investment program and as such do not invite consideration as a medium for trading in and out of the market. Nevertheless, the possibility is ever present that the shareholder may be obliged to sell his holdings. It is, therefore, a source of satisfaction to him that a firm market exists for the sale of his shares."

And in the following paragraph it is explained that shareholders are entitled to receive not less than 99 percent of the liquidating value of their investment upon withdrawal.

I leave it to the committee to judge whether the contents of this booklet indicate any misrepresentation, to say nothing of gross fraud.

I have shown you how misleading I believe Mr. Bane's testimony to be on this point. But even so, if Mr. Bane had read all of the supplemental literature issued by my company in the last 5 years, he would not have found a single instance in all that material of our having confused any of our companies with savings banks or any other similar institution, with the exception of the one example which I have just discussed. In all, we have issued 22 booklets and pamphlets containing some 191 pages and about 61,000 words.

In conclusion, I would like to remark that I am unschooled in the technique of presenting testimony, and I therefore desire to have it known that if my testimony appears to reflect any degree of ascerbity, it is certainly not intentional. I mention this because the testimony on the subject of pricing appears to have developed on something of a personal basis between Mr. Bane and myself. I have not, however, been talking to Mr. Bane on a personal basis; I have merely been presenting my testimony and answering his to the best of my knowledge and ability. I want the committee to know that I have a high regard for Mr. Bane personally and as a Government official. My associates and I have worked with him for a number of years and have always found him to be both understanding and cooperative.

I would like to add that Mr. Bane, as well as other Securities and Exchange Commisison witnesses, have had a difficult task to perform. They have had to study and report on a forest of statistical data and written analyses without the benefit and advantages of personal experience in the investment-trust business. This, plus the existence of many large and knotty trees on the edge of that forest of data, tends to obscure the business realities, the human traits of character and honorable intentions and the background of economic conditions in which the industry has developed—all of which are fully as important to consider as words and figures.

I honestly believe that there is far less "evil," unethical practice and unduly selfish motive in the industry today than the Securities and Exchange Commission and staff seem to suspect. In connection with the subject of pricing, I believe that many of the highly controversial points have arisen simply because of a lack of thorough understanding of all the aspects of the matter, and this is said not unkindly. It is a complex matter having many ramifications.

It is, however, for this reason as supported by my testimony that I believe people in the industry possessing practical experience and knowledge (which has been broadened by the Securities and Exchange Commission study) should be given the opportunity to iron out the problems with which they are faced by self-regulation, as provided for under the Maloney Act. This is already being undertaken through a committee which has formally been appointed by the National Association of Securities Dealers, formed under this act.

May 2. 1940.

Exhibit A

The dollar volume of sales of Massachusetts Investors Trust over the last year or so has accounted for about 15 percent of the total sales of all 78 companies included in the Securities and Exchange Commission study. Thus, while the Trust is considerably larger in size than the average company in the industry, its volume of sales is also considerably larger.

I mention this to make it clear that the dilution figures on Massachusetts Investors Trust are not unduly distorted because of the size of the Trust, although I will grant that the dilution in the industry as a whole may be somewhat greater in the average than may be the case with Massachusetts Investors Trust.

Using Massachusetts Investors Trust as the basis for my estimates, I determined the dollar amount of so-called dilution on the Securities and Exchange Commission's basis of figuring [1] for all normal business days during the year 1939, and including the two abnormal days of September 11 and 19. In relation to the dollar amount of shareholders' interests, this came to fifty-six one-thousandths of 1 percent. For simplicity, I called it five one-hundredths of 1 percent (my first figure.)

Next, I added in the dilution which occurred on the other abnormal or semi-abnormal days, excluding only the unprecedented war market day on September 5. This calculation resulted in a so-called dilution figure of ninety-eight one-thousandths of 1 percent. I called it ten one-hundredths of 1 percent (my second figure.)

At this point, every business day in the year 1939, excluding only September 5, had been accounted for, and so my final figure of fifteen one-hundredths of 1

[1] I have explained in detail in previous testimony why I believe the Securities and Exchange Commission's basis of figuring dilution does not accurately reflect the true situation. I stand firmly on that testimony, and believe that if all factors are taken into account such dilution as may occur is considerably less than even the minute fractional percentage amounts which I have shown.

percent (representing an increase of 50 percent over the annual basis figure, as above) was just for good measure and to allow for a reasonable margin of difference between the figures for Massachusetts Investors Trust and whatever the figures for the industry might be.

To sum up, I figured the actual dilution on the Securites and Exchange Commssion's basis [1] in Massachusetts Investors Trust for the full year 1939, excluding only September 5, which it may be recalled was excluded from both the Securities and Exchange Commission illustration, as given in its original testimony, and from my illustration which elaborated on the Securities and Exchange Commission illustration and arrived at a figure of less than ten one-hundredths of 1 percent. I then increased this figure by 50 percent to allow for the possibility of greater dilution for the industry as a whole, arriving at an estimated figure of fifteen one-hundredths of 1 percent as a reasonable annual dilution figure for the industry under typical operating conditions.

General Capital Corporation,
Boston, Mass., May 2, 1940.

Senator Robert Wagner,
Chairman, Senate Banking and Currency Committee,
Washington, D. C.

Dear Sir: We have read a report of the suggestions (index No. 730) made to your committee a few days ago for an investment company bill to take the place of S. 3580 and should like to submit the following comments for the committee's consideration. We would appreciate it if you would include this letter in the record of the committee's hearing on the bill.

ITEM 7. REGISTRATION OF INVESTMENT COMPANIES, SECTION 8 OF S. 3580

All open-end companies are already registered with the Securities and Exchange Commission under the Securities Act of 1933 and some companies, including General Capital Corporation, are also registered under the Securities and Exchange Act. The proposed additional registration would make three registrations with the Securities and Exchange Commission, each one of which would duplicate almost all of the information in each of the others but in a form sufficiently different to involve considerable unnecessary effort and expense.

We believe the bill should provide for the elimination of this duplication as far as possible.

ITEM 9. AFFILIATIONS OF DIRECTORS, SECTION 10 OF S. 3580

The proposed restriction would not add anything to, but would take away from, the present rights and powers of stockholders over their managements. We do not see how the taking away of these rights and powers could be expected to work out to the advantage of the stockholders. We do not believe that directors who are elected solely to satisfy a legal restriction such as the restriction proposed are likely to add anything but needless complications and expense to the operation of a company.

We do not believe that stockholders would exercise their right to elect fully competent unaffiliated directors if the proposed restriction were made a part of the law to any greater extent than they do at present without such a restriction. We do not believe that misconduct of affiliated directors would be less with the proposed restriction than without it.

We believe the proposed restriction would be harmful in many cases both to stockholders and to honest managements, particularly among the smaller companies.

1. We believe protection of stockholders against misconduct of directors and officers should take the form of requirements for publicity and restrictions against certain kinds of action without publicity and without stockholders' approval rather than the form of restrictions on outside affiliations and activities. We believe the proposed bill would adequately protect stockholders in its requirements for publicity and restrictions against certain kinds of action.

2. We believe restrictions on outside affiliations would, in most cases, result at best in the election of some directors who would be more or less uninformed and subservient to the others, in whom the effective control of the manage-

[1] Footnote 1 is printed on page 1095.

ment would lie, or at worst in inefficiency resulting from conflicts among directors.

3. We believe affiliations of directors are, in many cases, the best means for: (*a*) Insuring that a trust will have the benefit of a responsible, competent, continuing investment and management organization; (*b*) defining and limiting responsibilities, costs to be borne by the trust, costs to be paid for from the management fee, etc.; (*c*) assuring a trust of background of responsibility, financial and otherwise, over and above the responsibility of unaffiliated individual directors of the trust, etc.

Many companies and firms provide trusts which they manage with services and practical guaranties of substance which the trusts standing alone could not possibly duplicate except at an unreasonable cost, if at all.

Whether the people who participate in the management compensation do so indirectly through a management company, a management contract, etc., or receive their participation directly as directors, officers, etc., is, in our opinion, immaterial where the management arrangements are made entirely clear to the stockholders. If other restrictions do not adequately protect stockholders such other restrictions, in our opinion, will not be made more effective by taking away from stockholders any of their rights to elect directors of their own choice.

Very truly yours,

Francis I. Amory,
Vice President.

E. R. Kittredge,
Treasurer.

(Exhibit submitted by Securities and Exchange Commission:)

[From the New York Times, financial section, May 5, 1940]

GIVES LISTING RULE FOR SENIOR STOCK—EXCHANGE DECIDES ON MINIMUM VOTING RIGHTS TO ACCEPT PREFERRED SHARES

New preferred stocks which do not provide certain minimum protections for holders may not be listed on the New York Stock Exchange, according to an announcement yesterday. These minimum voting rights would allow the preferred stock, voting as a class, to elect not fewer than two directors after default of six quarterly dividends and would require the affirmative approval of at least two-thirds of the preferred for any charter or bylaw amendment changing its rights.

In announcing this new requirement for listing the committee on stock list of the stock exchange made the following statement:

"Since 1926 the New York Stock Exchange has refused to list nonvoting common stock. For several years the exchange, without formal announcement, has been extending this policy to preferred stock not possessing the right to at least one vote per share after recurrent defaults of dividends. However, it has been observed that in most instances in which preferred stock receives only one vote per share that right has been of small practical effect because of the numerically superior voting power of the common stock. Recently, in considering issues proposed for listing, the exchange has been exerting its influence to obtain voting rights sufficient to insure the preferred stockholders at least representation on the board of directors upon recurring defaults of dividends.

"PREFERRED STOCKS' RIGHTS

"The right of preferred stockholders to vote under certain circumstances is now receiving more general recognition. For example, many preferred stocks provide for representation of the class on the board after dividend defaults and the right to elect a majority of the board after a specified number of recurrent defaults.

"There is also a noticeable trend in new preferred issues to prohibit changes in protective provisions, the issuance of senior securities, and dilution, either by charter amendment, reclassification, merger, or other means, without the affirmative approval of the preferred stock as a class.

"MINIMUM RIGHTS NEEDED

"The circumstances under which different preferred stocks are issued, and their relation to the capital of different companies present such variety that the committee on stock list does not believe it desirable at this time to establish definitive standards of the adequacy of voting rights as a uniform listing requirement applicable to all cases. However, the committee feels that, to qualify for listing under the label of a 'preferred stock,' preferred stock should at least have certain minimum rights, both for representation on the board of directors after dividend defaults and for protection against a compulsory change in its existing provisions, even if such minimum voting rights are not granted under the laws of the particular State of the company's incorporation.

"Therefore, the committee on stock list has decided that, as a matter of policy, it will not list new preferred stocks which do not provide at least the following minimum voting rights:

"1. The right of the preferred stock, voting as a class, to elect not less than two directors after default of the equivalent of six quarterly dividends.

"2. The affirmative approval of at least two-thirds of the preferred stock, voting as a class, as a prerequisite to any charter or bylaw amendment altering materially any existing provision of such preferred stock.

"While preferred stocks with the above provisions will satisfy present listing requirements, these minimum standards are not to be regarded as the opinion of the committee on stock list as to the adequacy of protective provisions under all circumstances. The committee is hopeful that issuing companies and underwriters will continue their efforts for the improvement of the voting position and protective rights of preferred stock beyond these minimum listing requirements.

"The new policy will not be applied retroactively to issues already listed, many of which do not conform to the above standards."

Wellington Fund, Inc.,
Camden, N. J., May 3, 1940.

Hon. Robert Wagner,
Chairman, Senate Banking and Currency Committee,
Washington, D. C.

Dear Sir: I am writing this letter to correct an error in the transcript of the testimony in the matter of the investment-trust bill S. 3580. The errors occur on index 778 and 780 concerning the questions of redemption provisions in open-end companies.

The documentary evidence submitted by the Securities and Exchange Commission, presumably through Mr. David Schenker, counsel, is in error when it states that the Wellington Fund redemption rights may be changed and amended by the directors. In the Wellington Fund all investment restrictions, redemption rights, and other matters are defined in the bylaws, but the bylaws also contain a provision that the investment restrictions and liquidation rights may not be removed without approval of a majority of the stockholders.

A copy of the bylaws evidencing the foregoing provisions is attached hereto.

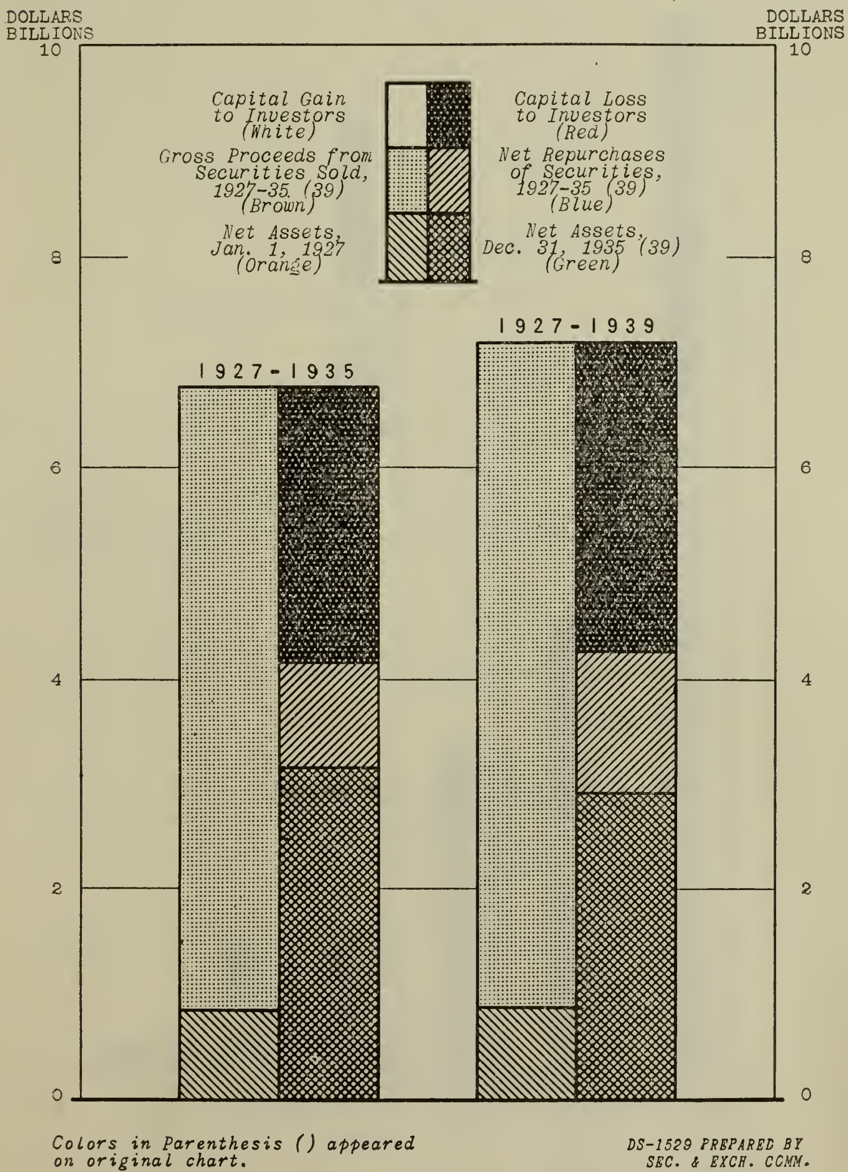
I am sending a copy of this memorandum to Mr. Schenker in order that he may correct the record for the statement erroneously made.

Yours very truly,

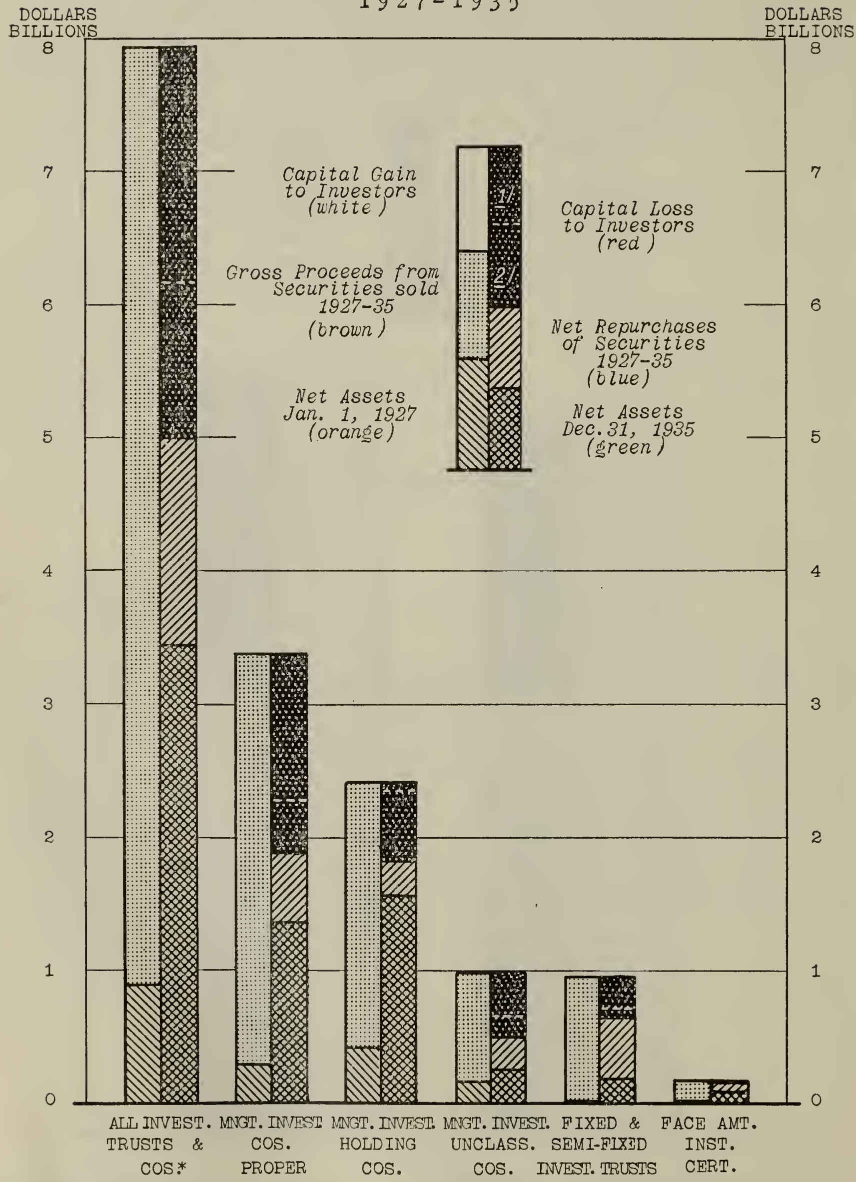
Walter L. Morgan, *President.*

(The following charts were submitted by Raymond W. Goldsmith, Trading and Exchange Division, Securities and Exchange Commission, and are referred to in pt. 2, p. 821:)

INVESTORS' EXPERIENCE IN
MANAGEMENT INVESTMENT COMPANIES



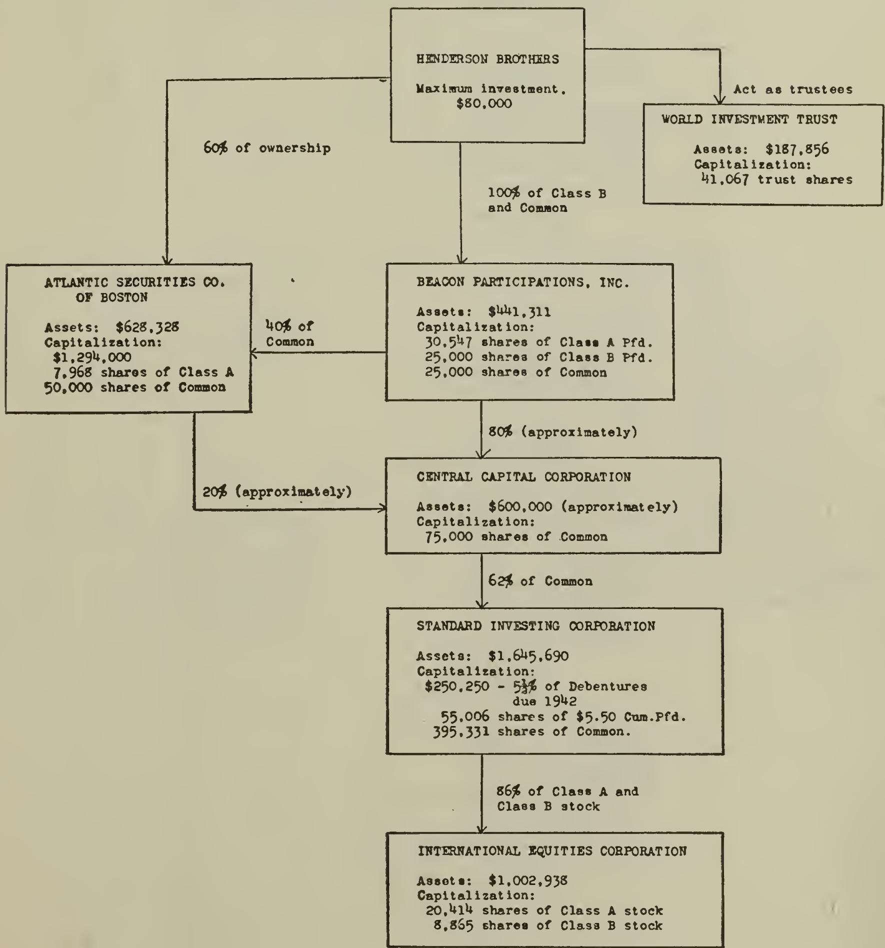
INVESTORS' EXPERIENCE IN INVESTMENT TRUSTS AND INVESTMENT COMPANIES*
1927-1935

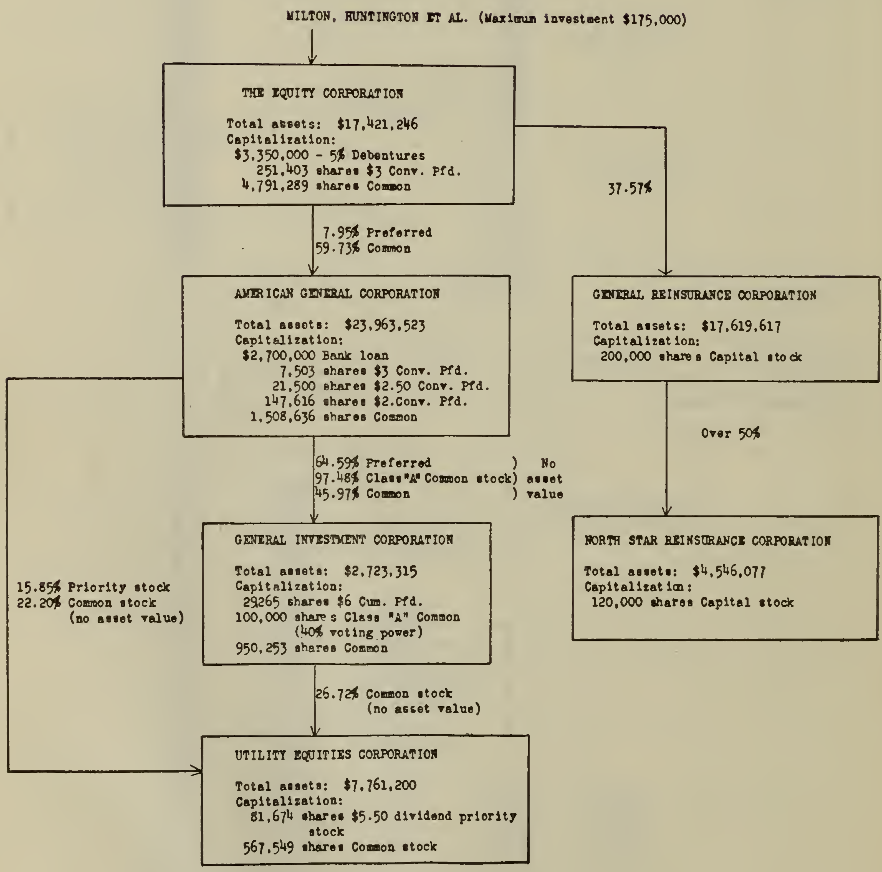


1/ Net Loss to Investors
2/ Interest & Dividends Paid, 1927-35
* Excluding Common Trust Funds & Installment Investment Plans
Colors in Parenthesis () appeared on original chart.

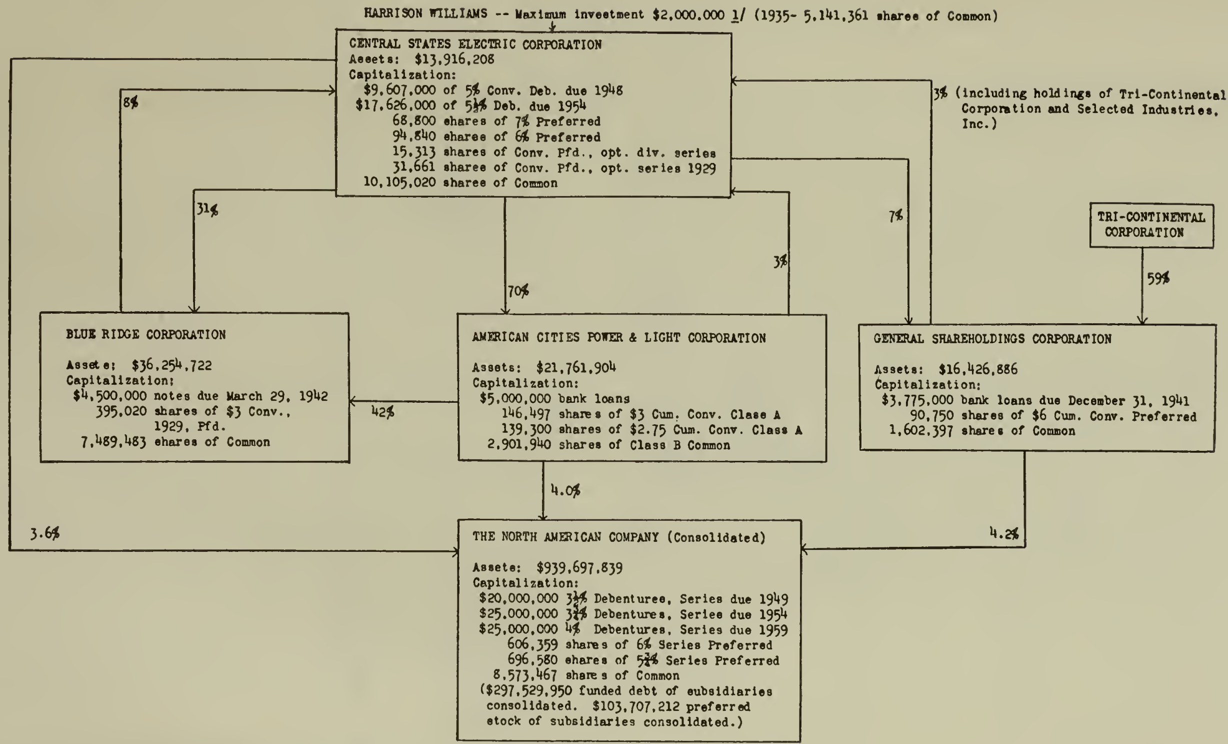
DS-1528 PREPARED BY SEC. & EXCH. COMM.

(The following charts were submitted by Mr. David Schenker, Chief Counsel, Investment Trust Study, Securities and Exchange Commission, and are referred to in pt. 2, p. 967:)




MILTON, HUNTINGTON ET AL. (Maximum investment $175,000)
THE EQUITY CORPORATION
Total assets: $17,421,246
Capitalization:
$3,350,000 - 5% Debentures
251,403 shares $3 Conv. Pfd.
4,791,289 shares Common
37.57%
7.95% Preferred
59.73% Common
AMERICAN GENERAL CORPORATION
Total assets: $23,963,523
Capitalization:
$2,700,000 Bank loan
7,503 shares $3 Conv. Pfd.
21,500 shares $2.50 Conv. Pfd.
147,616 shares $2.Conv. Pfd.
1,508,636 shares Common
GENERAL REINSURANCE CORPORATION
Total assets: $17,619,617
Capitalization:
200,000 shares Capital stock
Over 50%
64.59% Preferred) No
97.48% Class "A" Common stock) asset
45.97% Common) value
GENERAL INVESTMENT CORPORATION
Total assets: $2,723,315
Capitalization:
29265 shares $6 Cum. Pfd.
100,000 shares Class "A" Common
(40% voting power)
950,253 shares Common
NORTH STAR REINSURANCE CORPORATION
Total assets: $4,546,077
Capitalization:
120,000 shares Capital stock
15.85% Priority stock
22.20% Common stock
(no asset value)
26.72% Common stock
(no asset value)
UTILITY EQUITIES CORPORATION
Total assets: $7,761,200
Capitalization:
81,674 shares $5.50 dividend priority stock
567,549 shares Common stock

HARRISON WILLIAMS' GROUP OF INVESTMENT COMPANIES
December 31, 1939



1/ All of this investment was returned as dividends and as profit in the sale of a portion of his holdings.

PACIFIC SOUTHERN INVESTORS, INC. GROUP
December 31, 1939

PACIFIC SOUTHERN INVESTORS, INC.

Assets: $7,556,250
Outstanding stock:
68,573 3% Cum. Preferred
163,856 Class A
536,865 Class B

[Insiders' interest (Lovelace, McKee et al.) -- 110,555 Class A or 16% of total outstanding.] -- $139,000 investment

39.17%

INVESTMENT COMPANY OF AMERICA

Assets: $4,441,840
Outstanding stock:
216,415 shares of Common

27.92% of $3. Pfd.
12.85% of Class A
11.85% of Class B

AMERICAN CAPITAL CORPORATION

Assets: $5,460,897
Outstanding stock:
25,118 shares of $5.50 Prior Pfd.
89,400 shares of $3 Pfd.
110,472 Class A
632,662 Class B

INVESTMENT TRUSTS AND INVESTMENT COMPANIES

HEARINGS

BEFORE A

SUBCOMMITTEE OF THE
COMMITTEE ON BANKING AND CURRENCY
UNITED STATES SENATE

SEVENTY-SIXTH CONGRESS
THIRD SESSION

ON

S. 3580

A BILL TO PROVIDE FOR THE REGISTRATION AND REGULATION OF INVESTMENT COMPANIES AND INVESTMENT ADVISERS, AND FOR OTHER PURPOSES

PART 4

MAY 31 AND JUNE 4, 1940

Printed for the use of the Committee on Banking and Currency

UNITED STATES
GOVERNMENT PRINTING OFFICE
221147 WASHINGTON : 1940

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CONTENTS

INVESTMENT TRUSTS AND INVESTMENT COMPANIES

FRIDAY, MAY 31, 1940

United States Senate,
Subcommittee on Securities and Exchange of the
Banking and Currency Committee,
Washington, D. C.

The subcommittee met, pursuant to call, on Friday, May 31, 1940, at 10:30 a. m., in room 301, Senate Office Building, Senator Robert F. Wagner presiding.

Present: Senators Wagner (chairman of the subcommittee), Hughes, Herring, and Downey.

Senator Wagner. The subcommittee will come to order. Mr. Schenker, are you going to be the first witness?

Mr. Schenker. Judge Healy will be, sir.

Senator Wagner. Before we begin, I should like to read this telegram which I have just received. It is dated May 31, 1940, and is as follows [reading]:

Senator Robert F. Wagner,
Senate Office Building:

Air flight to Washington canceled last moment. Very sorry not to be with you. Undersigned heartily endorse revised bill, S. 3580.

Paul C. Cabot,
State Street Investment Corporation.
Tudor Gardiner, Inc., Investors,
M. E. Traylor,
Massachusetts Distributors.

You may proceed, Judge Healy.

STATEMENT OF ROBERT E. HEALY, COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. Healy. Picking up where we left off, my memory is that the hearings concluded the last Friday in April, and we had gone through nearly 4 weeks of hearings. Among the beneficial results were crystallizing of our own ideas, a better directing of our own thinking, and there was a sharpening of our own wits, as often comes out of debates of that character.

We had been impressed by several suggestions that were made during the course of the hearings by the committee, and then, finally, when Mr. Bunker spoke and stated that he thought a regulatory bill should be passed, he did not make the mistake which I submit some other industries have made in times past, of being merely critical and not offering anything constructive. He offered some constructive suggestions. I do not mean that we agreed with

everything that he said, but it was perfectly apparent that the suggestions were constructive, that they were honest, made in good faith, and were not merely "phonies."

Based on that, and after discussing it with my associates at the Commission and, as I understood it, with the approval of this subcommittee and the chairman, the members of the staff of the Commission have been in almost constant contact with the members of this industry, the gentlemen who appeared before the subcommittee, and their counsel, and with some other groups that did not appear.

The result is that we are now in position where we can say to the subcommittee that the industry, as represented by those gentlemen, and the Securities and Exchange Commission, are in agreement as to the recommendations which should be made to this subcommittee. The agreements were embodied in a memorandum, and an effort has been made to translate them into actual language. Of course, that is not always easy. There has been a redraft of the bill. There may have to be another one. But as the bill is now written it has the endorsement of the Securities and Exchange Commission, and it has the endorsement of the industry.

In order that there may be no misunderstanding, I would like to say a special word about title II, relating to investment counselors. We have talked with several representatives of investment counselors——

Senator WAGNER. That is on what page?

Mr. HEALY. Page 124, Mr. Chairman.

We have talked with a number of representatives of the Association of Investment Counselors. I am not able to say that we have come to a complete agreement with them. However, we have agreed with some of them. There are about two points outstanding that some of them object to. I should like to postpone any discussion of those two points because we may be able to come to an understanding on them.

I think it should further be said that we have had some discussion also with representatives of the companies selling face-amount certificates. They got into the matter rather late, and we have not had quite the same time with them that we have had with some of the others; and there, again, we are not able to tell the committee that as to the face-amount companies we are in complete agreement. We are able to say, however, that the points of disagreement have been reduced to not to exceed three, or possibly two.

Senator WAGNER. You are still in conference?

Mr. HEALY. Yes. It is my sincere conviction that within 48 hours we will come to an understanding with them.

Now, coming back to the really most important thing in the bill, that is, legislation as it relates to the open-end and closed-end management investment companies, we are in agreement. I do not mean to say by that that neither they nor we might not be at liberty to suggest a little change in phraseology where perhaps we have not succeeded in saying precisely what we mean to; but subject to that one caveat, we are in complete agreement.

I wish also to express to the subcommittee our feeling—and, of course, what weight you give to it is your matter—our feeling of great anxiety and a sincere conviction that the bill, if possible, ought

to be passed at this session. We believe that it will be a good thing for the industry. I think it is a good thing for the country to have an instance where a governmental body and a large industry can come before a congressional committee and say that they are in agreement as to their recommendations. I think it would be a contribution to recovery, and, strange as it may seem, I think that in the present scene of world conflict, instead of that being a reason why the bill should not be passed now, on the contrary, I think it is a reason why it should be passed. I think the investment trust, if properly handled—and I believe it will be—and if properly regulated—and I believe it will be—can, through contribution of capital, make a very definite contribution to national defense.

I believe that the bill is a good bill. I think it will work in the public interest.

Of course there has been some give and take here and there on it. We have convinced them of some things and they have convinced us of some things; but that does not mean that we do not support every provision in the bill as it is now written. We do not, of course, come to the subcommittee with the implication that these recommendations have to be accepted; but I do think that we have given consideration to every subject that any member of the subcommittee raised.

One other thing. I want to introduce to the subcommittee a gentleman who has worked with Mr. Schenker for all of these weeks as counsel for many of these investment companies. He has devoted nearly all of his time for the last month and a half to these conferences and attempted rewritings of the bill. He is a member of the firm of Sullivan & Cromwell—Mr. Alfred Jaretzki, Jr.

STATEMENT OF ALFRED JARETZKI, JR., MEMBER OF THE FIRM OF SULLIVAN & CROMWELL, NEW YORK, N. Y.

Senator Wagner. I think, Mr. Jaretzki, if it is agreeable to everybody, you might tell us to what extent you represent the industry.

Mr. Jaretzki. That is precisely what I want to do, Senator Wagner, and that is about all I want to say. I want to explain whom we represent and what we have done.

On behalf of the people whom we represent I want to endorse thoroughly everything that Judge Healy has said. Mr. Motley, who is sitting on my left, and I, have acted as counsel these last weeks for groups of the closed-end and open-end companies—Mr. Motley representing the open-end companies and I representing the closed-end companies.

Toward the close of the hearings the leaders of the groups who were down here and appeared before you got together and, in collaboration, worked out the memorandum which Mr. Bunker presented, which was the idea of this group of the industry as to what regulation should consist of.

After the hearings closed, as Judge Healy has said, with the approval of this subcommittee we carried on discussions with Judge Healy and Mr. Schenker to see if we could iron out the differences which existed between our proposals and theirs; and I want to say that, personally, and as far as my group is concerned, we have never

dealt with a fairer group of people than we did when we were dealing with Judge Healy and Mr. Schenker. On that basis it was very easy to narrow down the points of difference. I think we persuaded them of some points and they persuaded us of others.

Naturally there was a certain amount of give and take. It resulted in our reaching an agreement as to what we could jointly recommend to this committee in principle, which was embodied in a memorandum dated May 13.

These negotiations were carried on by a relatively small group, largely the group that appears here, and these gentlemen who sent you the telegram stating that they were unable to come down.

Before we presented these recommendations to your chairman we wanted to check with the industry to see if we could get the agreement of the leading factors in the industry to these proposals. We went back to New York and sent out this memorandum to all the leading investment trusts, to everybody who had appeared here, and to a great number of others, and held a meeting in New York, in my office, to discuss that memorandum. The principles of that memorandum were accepted by 56 investment companies, constituting by far the leading members of the industry.

We then proceeded, as Judge Healy has said, to try to translate these principles into a bill, and we learned, as we had suspected, that it is one thing to criticize a bill that somebody else has written, and it is quite another thing to try to write a bill yourself. But, working day and night with the Securities and Exchange Commission's staff, we were able to put into language the bill that was presented to you.

We had planned to have this week end to check back with the group who had endorsed the principles, but owing to the necessities of the time schedule, and in order to be prepared to come to this meeting, we had suddenly to send copies of this bill out Tuesday night and advise our friends that we would give them Thursday, Decoration Day, to tell us if they had any objections. That was pretty short notice. At first there were considerable objections to the time schedule, but when we explained the necessities of the situation everyone cooperated to the utmost, and we have received approvals from by far the great majority of people we were speaking for. We have had no objections from anybody. There have been some people whom we have not heard from, particularly from investment companies on the coast, who agreed in principle with the original memorandum and who indicated that they expected to agree with this, but they have not had time to be heard from.

We had a discussion last night on the telephone with an investment company in Chicago. I am just pointing out that it is a difficult thing to secure such a large group of approvals at short notice. But I think I can say to you that we have the approval of substantially the leaders of the industry and of practically everybody who appeared before you.

In particular I want to mention Mr. F. Wilder Bellamy, of Dominick & Dominick, who appeared before this committee and who telephoned me this morning to say that he was extremely sorry that he could not come down and appear at this meeting, but that the press of business in New York made it impossible, but he has heartily endorsed the bill.

The only gentleman that I remember who appeared before your committee and opposed legislation of any kind, also telephoned me last night endorsing this bill.

So, while we have not had time to get everybody in the boat, I think we speak for a very large percentage of the industry, and we feel that this bill is not only a workable bill, but is a bill which is a good thing for the industry. We would like very much to see it passed, and we hope very much that it can be passed at this session. The industry would like to feel that it has regulation behind it; that is, that we may know what the regulation is to be and that we will no longer live in uncertainty as to what the future holds for us. This is the type of regulation under which the industry feels it can work and which it feels will be very beneficial to the industry. We are hopeful that if this legislation passes it will constitute a stimulus to the investment company industry's contributing to venture capital.

I have a hope, and a number of us have discussed this, that out of this cooperation among ourselves and with the Securities and Exchange Commission there will result an association of investment companies which will work with the S. E. C. to improve even further the standards of the industry. We think that that will be helpful to the S. E. C. in administering this bill, to have an association to work with; and we are really very hopeful that we are at the start of something very useful and beneficial to the industry.

We feel also, that the critical period that we are going through now, rather than being a reason for postponing legislation, is, in our opinion, an added reason for passing this legislation. We feel that it would be helpful not only to the industry to have this legislation passed now, but also we feel that it is a very healthy sign that Government and industry can come together and do a constructive job of this kind.

STATEMENT OF WARREN MOTLEY, COUNSEL, MASSACHUSETTS INVESTORS TRUST, BOSTON, MASS.

Mr. Motley. I shall take but a few moments to express my complete endorsement of everything that has been said, both by Judge Healy and by Mr. Jaretzki.

I appeared at the hearings here as counsel for Massachusetts Investors Trust, primarily. When it became a matter of these negotiations, of trying to work something out, I was asked to act in general for the open-end industry, as Mr. Jaretzki was asked to act in general for the closed-end industry. We have worked very hard, all of us, with Mr. Schenker and his associates, and with Judge Healy's cooperation, for the last 2 weeks, and we have got something that is now presented to you that, as has been said, we can endorse. And while I have not been able actually to reach all of the members of the open-end industry, just as Mr. Jaretzki said, within the short time we have had over the holiday, everyone that I have heard from has endorsed the bill as it was sent to him, and we have not heard any opposition although we have received suggestions as to minor points.

Mr. Griswold is here, representing Massachusetts Investors Trust and Supervised Shares, and Mr. Hugh Bullock, representing the investment companies sponsored by the Calvin Bullock organization, and I talked on the telephone this morning with Mr. Tudor Gardiner, who expressed the regret of himself and Mr. Traylor and Mr. Cabot that the plane did not run this morning, as they all wanted to be here, and they asked me to say for them what they have said in that telegram as to their agreement.

The only other thing that I would like to add is that while we have worked very hard the last 2 weeks over this matter, it has been an extremely interesting experience to find with what cooperation we have been able to work in a thoroughly fair and honest effort on both sides to put into language, necessarily complicated, the principles which we had previously agreed to—which is not always an easy thing to do; misunderstandings can so readily arise. But all the problems have been faced both by ourselves, I think, and I am sure, by the S. E. C. representatives, with the utmost desire to be fair and to work into the bill all the provisions that we could persuade one another ought to be there.

I do not think I can add anything more.

Mr. Jaretzki. I would like the record to show Mr. Arthur H. Bunker, who appeared before you, is present, as are also Mr. Cyril Quinn and Mr. Raymond McGrath, who are members of the closed-end industry.

STATEMENT OF DAVID SCHENKER, CHIEF COUNSEL, INVESTMENT TRUST STUDY, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. Schenker. Senator, I would like to take a few moments to indicate broadly what are the differences between the revised proposals and the original proposals.

Senator Wagner. I think I speak on behalf of the entire subcommittee in congratulating you gentlemen on reaching an accord. It shows what can happen when reasonable men sit around a table. It also seems to me that cooperation between Government and industry, as is evidenced by the results here, is the way to secure reasonable, sound legislation. While I cannot speak for the subcommittee as to what ultimately will be adopted, I am sure they were all gratified when they heard that you gentlemen decided to confer with one another. I hope it sets an example for general cooperation.

Senator Herring. For the Congress, let us say, and especially for the Senate.

Senator Wagner. Yes.

Mr. Schenker. In section 1, "Findings," and in section 2, "Declaration of policy," a few changes have been made in phraseology to conform to the changes in the substantive provisions of the bill and are not of great consequence.

The definition of investment companies contained in section 3 is substantially the same as it was in the previous bill. Similarly, we have in section 3 taken every precaution to grant an exemption to every type of company which might be construed to be within the purview of the legislation but should not be within the legislation.

We have specifically enumerated additional exemptions, so that it will be notice unequivocally to everybody in that category that they are not within the purview of the bill.

Section 4, "classification of investment companies," is substantially the same as it was in the previous bill.

Section 5, "Subclassification of management companies," has been simplified, and two classes of companies have been provided for. One is known as the diversified company and the other as the nondiversified company, besides making the same distinction that we had in the previous bill; namely, you have open-end companies and closed-end companies, but these open-end companies and closed-end companies are further subdivided into two broad categories, depending upon what their investment policy is. If they have the policy of having no more than 75 percent of their assets invested in diversified securities, if they do not have more than 5 percent of their assets invested in not more than 10 percent of the outstanding securities of a company, they are diversified companies. Every other type of company is a nondiversified company.

We have not attempted to distinguish between them on the basis of capital structure, as we attempted in the other bill.

Senator WAGNER. Those are all removed, are they—the capital structure limitations?

Mr. SCHENKER. Those limitations are no longer incorporated in the classification of investment companies, but they are still dealt with in the substantive provisions. We have provisions relating to capital structure.

Senator WAGNER. Perhaps you misunderstood me. You remember that there was a provision putting a limitation on the amount of assets that can go into one security?

Mr. SCHENKER. Yes. That is in there. That is the basis of distinction between companies. The distinction in this draft is, do you diversify your securities and limit yourself with respect to the major portion of your assets, to not putting more than 5 percent of your assets in one company and not owning more than 10 percent of outstanding securities of that company?

You recall in the other draft we had a provision that a diversified company had to have one class of stock; it could not be pyramided, and a specified portfolio turn-over. Those other qualifications have come out of the classification of investment companies section, so that you have a simple classification, diversified and nondiversified companies.

Section 6 is substantially the same as the old section 6.

Section 7 is substantially the same. Subsection (d) on page 18, in essence, is similar to the provisions we had in the other proposed bill, except that now provision had been made that if an investment company that is organized under foreign laws can be subjected to the same policing that a domestic corporation is subject to, and if the Commission, by rules and regulations, can insure effective policing, a foreign company may be permitted to register.

You remember that under the old bill foreign companies could not register because we did not want to give them the sanction of being a registered company without being able to enforce all provisions against them. This carries through the same thought, except that we make provision that in the future, if we work out a system

whereby these foreign companies can be subject to comparable regulation, then the Commission is authorized to permit them to be registered, subject to those regulations.

Section 8, "Registration of Investment Companies," has been modified to include a provision for a detailed statement as to what the investment policy of the company is going to be—whether they are going to be diversified or nondiversified; whether they are going to borrow money; whether they are going to trade in commodities, whether they are going to be a trading company rather than an investment company. The language has been deliberately broad so as not to impede the management in its primary function of managing the portfolio, and yet to put the investor on notice as to the basic type of company that it is going to be. Instead of putting these limitations into the definitions, we have now put them into the registration statement, which will put an investor on notice as to what type of company it is going to be and what activities it is going to engage in.

Also, in order to accommodate another change made in section 9, this registration statement will give the Commission detailed information with respect to the officers, manager, investment adviser, and similar affiliated persons. These affiliated persons will not have to register as they would have had to do under the first draft. The company will furnish the Commission with information with respect to these persons.

Section 9 provides that any person who has been convicted for a securities fraud or has been subject to an injunction for a securities fraud cannot be an officer, director, or investment adviser of an investment company, instead of taking the approach that we did before, namely, that they had to file a registration statement and the Commission could deny them registration, and if such person has been so convicted or enjoined in connection with a securities fraud. In order to provide for the extreme or unusual or harsh situation, the Commission is given authority, in the event that a person has been convicted of a crime or subject to injunction, to still permit him to act if it feels, on the basis of all the facts, that it is not inconsistent with the protection of the investor, to permit him to act. That is to take care of the harsh case.

Senator WAGNER. How does that question arise, now? The company, of course, in filing its registration statement, will set forth these facts. Then does the company ask, notwithstanding the conviction, that he be permitted to act? How does the question arise?

Mr. SCHENKER. The bill says, on page 25, subsection (b) [reading]:

> Any person who is ineligible, by reason of subsection (a), to serve or act in the capacities enumerated in that subsection, may file with the Commission an application for an exemption from the provisions of that subsection.

Senator WAGNER. That will come subsequent to the registration?

Mr. SCHENKER. Yes. [Reading further:]

> The Commission shall by order grant such application, either unconditionally or on an appropriate temporary or other conditional basis, if it is established that the prohibitions of subsection (a), as applied to such person, are unduly or disproportionately severe or that the conduct of such person has been such as not to make it against the public interest or protection of investors to grant such application.

Senator WAGNER. It may not be in the registration statement. He simply makes an application?

Mr. SCHENKER. That is correct, Senator.

Senator WAGNER. Which is independent of any registration?

Mr. SCHENKER. Yes, sir; that is correct.

Section 10 has been simplified substantially. You remember it was quite a complicated provision in the previous draft.

Senator WAGNER. We heard a lot about section 10. I thought about it in my sleep.

Mr. SCHENKER. Although, Senator, the fundamental approach in both these bills is similar, you remember the underlying thesis of old section 10 was that if anybody stands to gain or lose from transactions in which he has some element of control, then provision ought to be made for independent representation. This new section 10 provides that 40 percent of the directors have to be independent of the managers, officers, and employees. It is stated the other way. It says, not more than 60 percent shall consist of persons who are managers, officers, or employees. This provision will provide the independent directorships where you have a management contract. In the situation where the directors are the brokers for the investment company or are investment bankers or are the principal distributors of the securities of the investment company, then a majority of the board has to be independent of those individuals. So you have a situation where there is no element of self-dealing—and I do not use that word in any offensive sense. In a situation where the director stands to gain or lose in a particular transaction, either as acting as investment banker for portfolio corporations, or acting as broker for the investment company, or acting as principal distributor for the securities of the investment company, in that case the board of directors has to be independent to the extent of the majority of the board from those individuals——

Senator WAGNER (interposing). That will require some readjustments?

Mr. SCHENKER. Yes; that will require some readjustments; and I think it is a tribute to the industry that they recognize the underlying philosophy of that provision. And be it said also that I do not think they really opposed the underlying philosophy, except that it was a matter of what protection was necessary to safeguard the situation. We feel that this will do it.

We have eliminated the other provisions which had prohibitions against interlocking directors between investment companies and the portfolio corporations which provisions had engendered such opposition. Under this bill today the director of an investment company can be on the board of a portfolio corporation.

Now, coming to section 11. The old section, as you remember, had a prohibition against organizing new companies if within a certain specific period you had organized another company. The major problem in connection with that situation was "switching" the investors from one investment company that you had organized to the new investment company that you organized. The approach that we have taken in the bill is that we have aimed at the abuse that grew out of the recurrent formations. We have provided that these exchanges shall be subject to the approval of the Commission, so that there shall not be any overreaching or imposition of heavy loads, and so forth.

Senator WAGNER. If there is an effort to organize another investment trust, that cannot be done unless it is approved by the Commission? Is that correct?

Mr. SCHENKER. No, Senator. There is no limitation now upon the number of investment companies that one sponsor can organize. However, the abuse in the past used to be that you would organize A Investment Co., and organize B Investment Co., and then go to the A security holders and say, "This trust is not as good as the new one. Why don't you get out of the A company and get into the B company?" There was a "switching," and it is that switching that we regulate rather than the organization.

Senator HUGHES. But you still have the companies?

Mr. SCHENKER. Yes. They cannot "switch" the investors. And, of course, Senator, the new companies will be subject to all the provisions in the bill. I think the fact that they are to be subject to all these provisions will tend to discourage the practice. It is not a simple matter any more to sponsor a new investment company. That combined with the fact that we still retain the minimum size requirement will certainly cut down very substantially the number of companies that an individual will organize.

Now, coming to section 12, that is the same as the old section 12 except in one respect. You remember that old section 12 said that under no circumstances can one investment company buy the securities of another investment company. The industry had some difficulty with that absolute prohibition under all circumstances. As a matter of principle they felt that if one investment company's securities happened to be a good buy, another investment company should be able to acquire such securities although they were conscious of the fact that pyramiding should not be any longer permitted. The compromise we worked out is that one investment company may own the securities of any investment company to the extent of 3 percent of the outstanding voting securities of the investment company, which means that in reality the acquiring company has no effective voice in the other investment company.

There is one exception for which we made provision, and that is this. If one company already owns a substantial block of stock of another investment company and, therefore, really controls it, then we felt that it did not make sense to prohibit that company from increasing its position in the company which it already controls. If it controls the company—already has got 30 or 35 percent of its outstanding voting securities—it ought to be able to get as much as it wants. That is a very salutary thing, in our opinion, because there may be situations where, if the contracting block can be built up to 66⅔, those companies may be consolidated in one structure.

At the suggestion of some insurance companies we have incorporated a provision, which has approval of the industry, to the effect that hereafter investment companies shall not buy a controlling interest in insurance companies. We think that is a salutary provision, because of the possible effect upon the insurance companies through the ownership by investment companies whose business it is to trade in securities, and so forth.

The provision we have is not unlike the one dealing with one investment company buying securities of another investment company, except that if it does not have any interest in the insurance

company at the present time it can buy up to 10 percent of the outstanding voting securities, but not more. So, in the future, no investment company can acquire more than 10 percent of the outstanding voting stock of an insurance company. The status quo is maintained. There are investment companies who have a controlling interest in insurance companies. We are not disturbing those situations.

Senator WAGNER. That is fixed now, is it? When you say you are not disturbing those situations, how do you provide for that?

Mr. SCHENKER. The bill says, after the effective date of this act no company shall purchase the voting stock of an insurance company if, as a result of the purchase, the investment company will have 10 percent of such company's voting securities.

The motivation for the inclusion of another provision which I am going to discuss is as much attributable to the industry, particularly to the suggestion of Dr. Sprague, as it is to the Commission. That is a provision which permits the formation of venture capital companies to participate in underwritings, furnish capital to industry, and make small loans to industry.

Senator WAGNER. Where is that in the bill?

Mr. SCHENKER. That is on pages 35 and 36. That provision states that a group of investment companies can buy an interest in a company to be formed where the primary business of this company shall be to promote industry, finance industry, underwrite, and make loans. The only participants in that type of company will be registered investment companies; and these registered investment companies cannot put more than 5 percent of their total assets into it, and there is a size limit of $100,000,000 for such venture capital companies.

Senator WAGNER. That is new, is it not?

Mr. SCHENKER. Yes, sir. We feel that it is a very salutary provision which may encourage the opening up of the capital markets. This is one of the things that we feel ought to impel the passage of the bill as soon as possible, so that we can get that type of thing working. This does not depend so much upon public participation. It depends upon investment companies who can take care of this company. There is no reason why an institution like that cannot function immediately after the passage of this bill.

Senator WAGNER. Five percent of the portfolio, did you say?

Mr. SCHENKER. No. No company can put more than 5 percent of its own assets in that type of company.

Section 13 is not unlike the original section 13, in that it says in substance that an investment company cannot change its investment policy as recited in its registration statement without getting the approval of the majority of its outstanding voting stock.

Senator WAGNER. Is that policy defined at all?

Mr. SCHENKER. In the registration statement, Senator, they are required to set forth what their investment policy is going to be with regard to specific items.

If you will look on page 20, these are some of the things we consider fundamental to investment policy. Starting with line 8:

(1) a statement in respect of the policy of the registrant in respect of—

whether you are going to be diversified or nondiversified; do you expect to issue senior securities; do you expect to engage in the underwriting business; do you expect to have concentration of investments

in a particular industry or group of industries—like a chemical fund or an aviation fund; do you expect to deal in real estate and commodities, or either of them, or loans to other persons; what is your policy with respect to portfolio turnover; do you expect to have a rapid or slow turnover, and so forth? In order to give a little rubber, we say that the company should not be hamstrung by those recitals but should have some freedom of action. However, the statement of policy will indicate to all persons what general type the company is going to be. As the company enumerates these policies in its registration statement, it will not be able to change them without a majority vote.

Senator WAGNER. You do not limit the type of securities? I see they may issue senior securities.

Mr. SCHENKER. That is right. I will come to that very soon.

Senator WAGNER. Yes.

Mr. SCHENKER. Section 14 relates to the size of investment companies: We have the minimum size of $100,000; but, instead of having a maximum size, we have made it a subject of study by the S. E. C., and a report to Congress.

The next, "Investment advisory and underwriting contracts," is substantially the same as it was in the other bill.

The "Changes in board of directors: provisions relative to strict trusts," is substantially the same as in the old bill, except we have put in a special provision for dealing with the Massachusetts type of trust.

Section 17, "Transactions of certain affiliated persons and underwriters," is substantially the same provision as in the old bill. These provisions prohibit self-dealing between the officers and directors and the investment trust. They cannot knowingly purchase from such registered company or from any company controlled by such registered company, any security or other property, except securities of which the seller is the issuer, and so forth. They cannot borrow money, and those other provisions are substantially the same.

Section 18, "Capital structure": Instead of having the provision that we had in the old bill—that in the future you can issue only one class of stock—we have agreed upon this recommendation to the committee that you could have as a maximum three different types of securities—debentures, preferred stock, and common stock. That is for the closed-end companies in the future.

With respect to the open-end companies, they can have only one class of stock. However, we have made provision to enable them to borrow from a bank, provided that at all times they maintain the ratio that we prescribe with respect to such bank borrowing by an open-end company.

With respect to the closed-end company in the future, the maximum number of securities they can issue is three different types—debentures, preferred stock, and common stock. They cannot issue debentures unless at the time they issue the debentures they have a 300 percent coverage for the debentures. That means they can issue debentures only to the extent of one-third of their total assets.

With respect to preferred stock, they cannot issue such stock unless it is covered 200 percent. They can issue preferred stock up to the extent of 50 percent of their total assets.

Debentures have to be covered 300 percent; preferred stock has to be covered 200 percent.

The total senior securities including bonds and preferred stock that can be issued is 50 percent of their total assets.

Senator WAGNER. What is the difference between the debentures and preferred stock? I know generally what the difference is, but what is the debenture in the sense in which you use the term?

Mr. SCHENKER. Well, the difference, Senator, is that the debenture is a debt which is a fixed charge. They have to pay the interest or they are in default.

Senator WAGNER. I see.

Mr. SCHENKER. In the case of preferred stock, they promise to pay them a fixed dividend, if earned; but if they do not earn it, the preferred stockholder does not get it.

Since the debenture holder gets a smaller return than the preferred-stockholder, and since he is a creditor of the company, rather than having an equity interest in the company, as the preferred-stock holder holds, he ought to have more security than the person who is a preferred-stock holder. That is the reason for distinguishing between those two situations.

Senator WAGNER. I understood you to say the debenture income is lower. It may be lower or it may be higher, depending on the earnings?

Mr. SCHENKER. Well, not depending on the earnings; because if a debenture holder is promised 4 or 5 percent return, that is all he can get. The preferred-stock holder usually gets the same, except he usually gets a little higher return. But if they do not earn it, the preferred-stock holder may not get anything.

Senator WAGNER. That is what I was talking about. You said the debentures usually had a lower income than the other securities, including preferred stock. However, it really is variable, and may or may not be?

Mr. SCHENKER. I meant they promise them a smaller return than they promise the preferred-stock holder, if they earn it.

Senator WAGNER. I see.

Mr. SCHENKER. With respect to dividends we have the provision that in the future, with respect to senior securities, not only must they have the requisite coverage of 300 percent for debentures and 200 percent for preferred stock, but they cannot pay dividends on the common stock unless the debentures are covered 300 percent; they cannot pay dividends on the common stock unless the preferred is covered 200 percent; and they cannot pay dividends on the preferred stock unless the debentures are covered 200 percent.

The theory of that is that the common-stock holder has no limit on what he may get, depending on what the earnings of the company are. He cannot get any dividends and draw off the earnings of the company, to the detriment of the preferred-stock holder and the debenture holder; he cannot get dividends unless the debentures are covered 300 percent and the preferred stock is covered 200 percent.

The distinction is made between the debentures and the preferred stock. He cannot get a dividend unless the preferred stock is covered 200 percent. You have to make a distinction between the common and the preferred, because the slightest decline in the assets

would prevent you from paying a preferred stockholder a dividend, even though it is a limited amount.

Section 20, "Proxies; voting trusts; circular ownership," is substantially the same as in the old bill.

Section 21, "Loans," is substantially the same as in the old bill.

With respect to dilution, we have this suggestion: That in the first instance the National Association of Security Dealers under the Maloney Act should deal with that problem to see if they can work it out within a year. After the year, the Commission can make rules and regulations with respect to that problem.

The approach is that if the dealers can work it out to the satisfaction of the Commission we shall be glad to see the industry police itself. If the Commission feels they have not dealt adequately with that problem in accordance with the standards set forth in the act, then the Commission can provide rules.

If the association adopts rules satisfactory to the Commission, then the Commission can make them its own, and everybody will be subject to them, whether a member of the association or not.

Senator WAGNER. That is interesting. Where is that?

Mr. SCHENKER. Page 65, section 22.

Senator WAGNER. All right.

Mr. SCHENKER. Page 70, section 23, "Distribution and repurchase of securities": In order to stop this practice in the old days of issuing stock of investment companies for personal services, this bill says that no company hereafter can issue any of its stock except for cash or securities. We have included provision that no company can sell its own stock below asset value, except in accordance with the limitations we have here prescribed.

In connection with the repurchases by closed-end companies of their own stock, we have made a provision that they can do it in the open market; they can do it by tenders, in accordance with such rules as the Commission may formulate. However, they must tell the stockholders, in advance, of their intention to repurchase their own stock, so that all their stockholders—and not only the officers and directors—know when the company is repurchasing its own stock.

That is a very salutary provision. The stockholder who is not an insider knows that the company is doing it, and he can make up his mind whether he wants to avail himself of the opportunity and sell his stock back to the company. He is approaching a parity of treatment with the insider.

Section 24, "Registration of securities under Securities Act of 1933," is the same as the previous draft.

Section 25, on page 73, "Plans of Reorganization"—you remember the old proposed bill provided that reorganizations should be subject to the approval by the S. E. C. That provision was opposed. The compromise we have worked out is that in connection with a reorganization which includes general offers of exchange.

Senator WAGNER. You are speaking of legal reorganizations?

Mr. SCHENKER. I am talking of voluntary reorganizations.

Senator WAGNER. Oh, yes.

Mr. SCHENKER. Reorganizations under 77 (b) we do not touch.

Senator WAGNER. Yes.

Mr. SCHENKER. There is a specific provision here stating that no provision here shall act in derogation of the power of the courts under the Bankruptcy Act.

But the voluntary reorganizations, mergers, and consolidations do not require the approval of the S. E. C. However, if any investment company that is involved in that type of transaction wants to get an advisory opinion from the Commission with respect to the fairness of the plan, the Commission is authorized to issue such an opinion on that plan; or if 25 percent of the security holders want the Commission's advisory opinion, they can get such an opinion.

Otherwise, the jurisdiction of the Commission is limited to the power to go to a court of equity and obtain an injunction against the plan, if the plan is grossly unfair. The term "grossly unfair" was selected in order not to include that type of situation where there may be a reasonable and honest difference of opinion as to the fairness of the plan. However, if it is obviously unfair, then the Commission is authorized to get an injunction and stop the consummation of the plan.

Senator WAGNER. Then of course there is the court review.

Mr. SCHENKER. Yes; then there is a court review; that is correct.

Senator WAGNER. I meant that the injunction, of course, in itself gives the court review.

Mr. SCHENKER. That is right; that gives the court the right to review the plan, to determine whether or not it is grossly unfair.

Senator WAGNER. Yes; or whether you are acting arbitrarily.

Mr. SCHENKER. Section 26, "Unit investment trusts," is the same.

Section 27, "Periodic payment plans," except for some changes in the language, in the technical aspects, is the same.

Section 28, "Face-amount certificate companies," Judge Healy has explained the situation on these companies. We hope to be able to agree with them by tomorrow; and then we shall submit to the committee a draft of the language.

Section 30, "Periodic and other reports," on page 89, is in some respects the same as the old draft, except there is a more detailed itemization of the items that have to go into the report to stockholders. Rather than having broad language, we attempted to set forth those things which the report should deal with.

Section 32, "Accountants and Auditors," is substantially the same as the old bill, except I should like to call the committee's attention to one factor that the next draft I should like to submit will include a provision that hereafter the accountant must be selected by the directors who are independent of the managers and the officers. Such selection has to be ratified at the next meeting of the stockholders; and the stockholders, by a majority vote, shall have the right to remove that accountant; and, fourth, any certificate or report of the accountant must be addressed to both the directors and the stockholders.

So that you have the element here of the accountant in the future having some responsibility to the stockholders. The initial selection will be made by the independents on the board of directors, and he will be in all respects the accountant for the stockholders as well as for the directors, Senator.

Senator WAGNER. Let me ask you this: How do you define an independent?

Mr. SCHENKER. Senator, an independent director is a director who is not an investment adviser to the company, he is not a partner of that investment adviser, and he is not an officer or employee of the company.

That is, the accountant has to be selected by those people on the board of directors who have no pecuniary affiliation with the manager and have no affiliation with the officers and directors.

Senator WAGNER. Yes.

Mr. SCHENKER. With respect to section 33, "Settlement of civil actions"—settlements of lawsuits—you remember that there was a provision in the old bill for the Commission's participating in that type of situation. What we have done with that is that we have made provision that in connection with certain types of lawsuits under certain conditions the information shall be filed with the Commission, so that the Commission can study that and see how to deal with that very important problem of representative actions against investment companies, so that we shall get the information with respect to that type of situation.

Section 34, "Destruction and falsification of reports and records," is virtually the same.

Section 35, "Unlawful representations and names"—so far as the future is concerned, we can stop any name that is misleading. So far as the present situation is concerned, it presents a somewhat more complicated problem. The Commission has the power, if the name is misleading in a material respect, to get an injunction restraining them from using that name.

We had to distinguish between new companies and old companies because certain goodwill has been built up with respect to existing names. You have the Tri-Continental Corporation. We do not want to stop that name, although a person might say, "I thought I was going to invest in a company which invested in securities of three continents." That name is not materially misleading and we do not want to disturb the goodwill that the company has built up.

However, in the future if a company wants a name of "Old Age Secured Investors," that type of representation and that type of name will be stopped.

We have incorporated a provision which gives the Commission the right to institute an action to get an injunction where the officers and directors and their affiliated persons are guilty of gross abuse of trust or gross misconduct—section 36, "Injunctions against gross abuse." In that case the Commission goes to court; and the person will have a right to have his case passed on by a court.

In connection with section 37, "Larceny and embezzlement," we have specifically incorporated that provision because of the difficulties that we see the Federal Government has encountered in connection with the enforcement of any of its acts. The Government is required to spell out a mail fraud case. This bill contains a provision that anybody guilty of embezzlement of investment company funds shall be guilty of a Federal crime and shall be prosecuted for that crime.

With respect to section 38, "Rules, regulations, and orders; general powers of the Commission," I think the only substantial change there

is that we have made provision that before the rules and regulations are formulated, the Commission, as a matter of policy, should confer with the representatives of the industry before it formulates its rules.

In order not to create other problems of jurisdictional defects, we have attempted to eliminate that aspect of the problem by saying that the Commission is not bound by the record and, therefore, can rely on its own knowledge and information and other sources of information. The record made does not constitute a basis for review.

The principle is that it is a statement of the declaration of the policy of the Congress. The S. E. C., before it formulates its rules and regulations, should continue the practice it has followed in the past, of conferring with the industry before it formulates the rules and regulations.

I think that is substantially right, is it not, Mr. Healy?

Mr. HEALY. Yes.

Mr. SCHENKER. The rest of the provisions are similar, except I should like to make this observation: that we have not given the definitions the same thorough going over that we have given the other sections; and we are still polishing those definitions. We hope to make them available in the future for the committee's consideration.

Senator WAGNER. Of course I have not read the bill; but in connection with the making of rules, you say that a policy should be expressed for consultation with the industry's representatives? I was not very clear about that.

Mr. SCHENKER. Yes; on page 101, Senator, section 39 (b).

Senator WAGNER. What are the mechanics of it?

Mr. SCHENKER (reading):

> It is hereby declared to be the policy of the Congress that, before issuing under this title any rule or regulation which affects the substantive rights, privileges, or obligations of any class or classes of persons, the Commission or appropriate officers of the Commission consult with representatives of the classes of persons thus affected, if and to the extent that such consultation is practicable and consistent with the public interest. It is likewise declared to be the policy of the Congress that whenever there is a substantial demand for a public hearing regarding the provisions of any such rule or regulation, and under the circumstances such a hearing appears practicable and in the public interest, such a hearing be held before the issuance of such rule or regulation. The effectuation of the policy of this subsection is committed exclusively to the Commission, which shall not be bound or confined to any record made in the course of any such consultation or public hearing, and the exercise of the Commission's discretion hereunder shall not be subject to judicial or other review; but it shall be the duty of the Commission, in each annual report submitted to the Congress pursuant to section 42, to describe the practices and experience of the Commission under this subsection during the preceding year.

Unless you have phraseology like that, Senator, you may get yourself into difficulties every time you formulate a rule or regulation. The question may be raised: "Did you conform with the precise method of giving notice?"

Or you may get yourself into a situation where nobody shows up for a hearing where, apparently, no one has any interest and no formal record is made.

Senator WAGNER. These rules and regulations are not subject to review at all, are they?

Mr. SCHENKER. Yes; they are.

Senator WAGNER. I thought you read that they are not.

Mr. Schenker. No; I said—

The effectuation of the policy of this subsection is committed exclusively to the Commission, which shall not be bound or confined to any record made in the course of any such consultation or public hearing, and the exercise of the Commission's discretion hereunder shall not be subject to judicial or other review.

Senator Wagner. Oh, yes; I misunderstood.

Mr. Schenker. I thought the record should indicate unequivocally that to no small extent the industry itself is responsible for the inclusion of this provision, as well as the Commission. They feel that this is a way, so far as the industry is concerned, of dealing with the whole subject of rules and regulations.

Senator Wagner. How do you determine whom in the industry you should notify? You do not have anything in the law about that.

Mr. Schenker. If they have an association, then it is a comparatively simple matter.

Senator Wagner. Yes.

Mr. Schenker. The fact of the matter is that in the past, Senator, before any rule—so far as I know, and I was in the Trading Division and in the Investment Trust Division——

Senator Wagner. Yes.

Mr. Schenker. Before any rule was formulated the Commission called in the people who were affected by it. If it affected exchanges, we consulted with the representatives of the exchanges; if it affected underwriters, we called in the underwriters.

Here we had no difficulty in getting the representatives of $2,500,000,000 to $3,000,000,000 of the industry to talk to us for a period of 11 weeks. The Commission has always followed, so far as I know, this procedure.

As I say, that has been the general policy, although I am not sufficiently familiar with every instance of the formulation of a rule or regulation by the Commission.

Senator Wagner. Yes.

Mr. Schenker. But that is what the Commission has attempted to do. This bill contains a codification of this practice and an expression of intent of what the Commission expects to do in connection with rules and regulations in the future.

Mr. Healy. If I may interpose for just a moment, please?

Senator Wagner. Yes.

Mr. Healy. I do not believe that, when you get to the point of trying to write a rule, you can get much benefit or put much dependence on the mere legal formalities; that is, if you can sit down around a table with a group of people who are interested in a particular subject and discuss what a rule ought to be, I think you accomplish a great deal more than when you make a formal record and have a lawyer make a speech.

Senator Wagner. Yes.

Mr. Healy. By this method that this statute envisages, you are also in a position where, if you have had some experience—as most of us have had down there—in the particular subject with which you are dealing, you are not expected to throw that experience out of the window, when you come to write the rule, and give your attention merely to formal testimony any more than a member of this com-

mittee, when he comes to deal with legislation, may not use his own common sense and knowledge as well as anything that is in the record.

Also you have to look out for the unpredictable emergency which comes up, as it frequently does, where you have to write a rule in a hurry or, again, to repeal a rule in a hurry.

For example, if the S. E. C. found itself in the position where it was very desirable to suspend trading on the stock exchange for any length of time or to suspend trading in particular securities—which we have authority to do to a limited extent and to a further extent with the approval of the President—if the situation were bad enough to warrant any such action, I do not think there would be very much time for court reviews, notices, and formal records.

Senator WAGNER. Yes.

Mr. HEALY. And a great many of the rules that we pass, especially in the nature of exemption rules, are rules that are proposed by the various industries; they are for their benefit.

Senator WAGNER. Then, it was the industry that suggested this particular provision? Is that so?

Mr. HEALY. My memory is that this suggestion originated with Mr. Jaretzki, during the hearing. Is that right?

Mr. JARETZKI. That is right.

Mr. SCHENKER. Senator, if I may be so bold as to express a personal word, I think I ought to express my personal appreciation of the most valuable help given us by the industry, particularly Mr. Alfred Jaretzki of Sullivan & Cromwell, Mr. Warren Motley of Gaston, Snow, Hunt, Rice, & Boyd, and Mr. Paul Bartholet of the Tri-Continental Corporation, and the assistance of Mr. Charles Jackson, Jr., of Gaston, Snow, Hunt, Rice, & Boyd, and Mr. John Sheffey, of the Tri-Continental Corporation, who have worked day and night with us to try to put this proposed bill in proper shape.

Senator WAGNER. You are all to be complimented. I think it has been a magnificent cooperative result.

Senator HUGHES. We appreciate the cooperation very much; because, of course, we do have doubts about a great many of the things; and we are glad that the industry itself has tried to cooperate in working out a real plan. It is very helpful to us.

Senator WAGNER. In talking it over with the Senators, I know that one of the things about which we were concerned was this: While we were very anxious to remove the abuses, we did not want to do anything that would injure legitimate industry; and that is a problem that you gentlemen, yourselves, have solved, I think.

Now, we shall have to hear from the representatives of the face-amount companies; and then what else is there to be done?

Mr. HEALY. The investment advisers—that is, we may not be able to agree; and if we cannot, then we shall report back to the committee as to the respects in which we can agree and the respects where we disagree.

Senator HUGHES. It ought to be done very soon.

Mr. HEALY. Yes; I think Monday morning ought to be the latest and should be the deadline. I think the committee could very properly fix it.

Senator HERRING. It looks as if you are going to get along with the face-amount companies.

Mr. SCHENKER. Senator, I have been meeting with them day and night. They have been very helpful, and I think we can get together.

In connection with the investment advisers, I think that Robert Page who represented Scudder, Stevens & Clark—you remember Mr. James White of that firm testified with respect to that bill—submitted a draft of the bill to us, which is the draft that is included in this new bill. I have not heard any opposition from any investment advisers. I cannot say and Judge Healy cannot say—as we are able to say with respect to the close-enders and the open-enders—that we have their affirmative approval. The only thing we know is that they have not disapproved the bill. We do not have the same affirmative approval with respect to that title of the bill as we have with respect to title 1.

That does not mean that anybody is opposed to it or that anybody besides Scudder, Stevens & Clark is for it. Do you see what I mean?

I know of no way of being able to say to the committee that this title 2 has the same sanction that title 1 has.

There are just one or two slight changes in title 2: and I personally feel that there will not be any vigorous objection to it. I think we have tried to meet all the objections that were asserted at the committee hearing.

Mr. HEALY. May I say one further word?

Senator WAGNER (chairman of the subcommittee). Certainly.

Mr. HEALY. That is this: If we do not come to an understanding with the face-amount people, I think it is quite possible that we shall recommend to the committee that the provisions relating to face-amount companies be dropped from the bill completely, and that they be made the subject of separate study and separate legislation.

In other words, if there is a chance of getting the rest of the bill through without that, then I think it is wise to take it.

Senator HERRING. I think that is wise.

Mr. SCHENKER. Yet, on the other hand, in fairness to them, I think the record should indicate that they want legislation and are trying to cooperate with us; and if they can work it out, I think it ought to be included. I think legislation will be helpful to them and will be helpful to the investors.

Senator HERRING. Is not one of the difficulties with them the matter of transfer of securities?

Mr. SCHENKER. On that aspect they do not really disagree with us.

Senator HERRING. No; but are there not difficulties?

Mr. SCHENKER. They say they have difficulties with five States which, by statute, require them to make a deposit with the State's securities commissioner. They would love to see a situation where they can deposit with a central depository.

Senator HERRING. Yes.

Mr. SCHENKER. The question in Judge Healy's mind and in my own mind is as to which is the most effective way of accomplishing that end. Shall we attempt at this time—which would be a great help to those companies—to include in this legislation such provision which would put everybody in the country who is a certificate holder in that type of company on a parity?

What is the best way to accomplish that purpose? Is it to let the status quo go on, so far as the future is concerned, to prevail upon the securities commissioners to conform to a new policy to be contained in this bill.

Senator HERRING. You see our position. We are protecting our face-amount policyholders and are taking care of them, and we are not going to give up that security, for some State that does not take care of them.

Mr. HEALY. We have the problem of future sales.

Senator HERRING. Yes; that is all right.

Mr. HEALY. They are in trouble with future sales; because they are not permitted to make sales in certain States without making certain deposits. It seemed to me that Congress should not consciously or expressly permit inequalities between its own citizens. in the administration of the law.

Senator HERRING. Not in the future.

Mr. HEALY. That is right. So our problem seems to be to try to work out some scheme with the face-amount people whereby they can satisfy State requirements and at the same time prevent any inequality and create the same kind of protection for all of their investors all over the country, that a few good State commissioners have succeeded in doing here and there.

Senator HERRING. Of course, that will require legislation in these States, before they can do that.

Mr. HEALY. I think it may possibly be done without that.

Senator HERRING. You will have to change our statute which compels them.

Mr. HEALY. No; under this suggestion, which I heard for the first time last night—and I am not committed to it—but under the suggestion I heard last night, they would continue to make deposits, just as the State law requires, and then they would make a deposit with the national agency, which would be maintained at such a rate that in case of the liquidation of the company, all the security holders would receive approximately the same rate of return.

Senator HERRING. Could we make a double deposit?

Mr. HEALY. It would not require a double deposit.

Senator HERRING. It would not?

Mr. HEALY. What would happen if the company went into bankruptcy would be this: The people in your State should use up the deposit; and then if it had not been paid for in full, when they came to take their share out of the national deposit, there would be an equalization process there, so that their share of the settlement recovered would be the same as everybody else's. But in the meantime they would have that deposit.

Senator HERRING. Yes; it might be done in that way. Then they would have all the security?

Mr. HEALY. Yes.

Senator HUGHES. Mr. Chairman, I move that we recess or adjourn, to meet on Tuesday morning.

Senator HERRING. Do you have a regular meeting Tuesday?

Senator WAGNER. I do not think we have a meeting of the full committee then.

Mr. Schenker. And by that time we hope that we shall be able, on Tuesday, to give you a final bill, down to the last comma and period.

Senator Wagner (chairman of the subcommittee). Yes; and then the rest is up to the full committee; and I cannot predict what they will do. Thank you.

Mr. Schenker. Thank you, Senator.

Mr. Healy. Thank you, sir.

(Thereupon, at 12 o'clock noon, a recess was taken until Tuesday, June 4, 1940, at 10:30 a. m.)

INVESTMENT TRUSTS AND INVESTMENT COMPANIES

TUESDAY JUNE 4, 1940

United States Senate,
Subcommittee on Securities and Exchange
of the Banking and Currency Committee,
Washington, D. C.

The subcommittee met, pursuant to adjournment, on Friday, May 31, 1940, at 12:30 a. m., in room 301, Senate Office Building, Senator Robert F. Wagner presiding.

Present: Senators Wagner (chairman of the subcommittee), Hughes, Herring, and Downey.

Senator Wagner. The subcommittee will come to order.

We have before us the confidential committee print of June 4, 1940, of S. 3580. Judge Healy, we will be glad to hear from you.

STATEMENT OF ROBERT E. HEALY, COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. Healy. Mr. Chairman and members of the subcommittee, we are still in agreement with the investment-trust industry.

Senator Wagner. I believe there was one question left open at our meeting on last Friday. That was in reference to the face-amount companies so-called, was it not?

Mr. Healy. That is right.

Senator Wagner. And you expressed at that time confidence that these companies and the Securities and Exchange Commission would reach an agreement.

Mr. Healy. Yes.

Senator Wagner. Has an agreement been reached on that matter?

Mr. Healy. Yes. We have reached an agreement with the only representative of the face-amount companies we have been in contact with, and that agreement is embodied in the redraft of sections 28 and 29 as now appear in the June 4 print of S. 3580.

I might say that the lawyer who represents one of the largest face-amount companies—and there are only two large ones—the Investors Syndicate, is here, and also one of their officials, Mr. Crabb.

Senator Wagner. Who will speak here for them?

Mr. Healy. I presume the attorney—no; I am informed that Mr. Crabb will speak.

Senator Wagner. We will be glad to hear Mr. Crabb.

STATEMENT OF E. E. CRABB, PRESIDENT, INVESTORS SYNDICATE, MINNEAPOLIS, MINN.

Senator WAGNER. How do you spell your name?

Mr. CRABB. It is spelled C-r-a-b-b.

Senator WAGNER. Will you give your full name so we may have it on the reord?

Mr. CRABB. My name is E. E. Crabb, president, Investors Syndicate, Minneapolis, Minn.

Senator WAGNER. We will be glad to hear from you.

Mr. CRABB. I might say that our company was organized in 1894 and has been in continuous operation ever since. We have something over 350,000 certificate holders, and our gross assets amount to slightly over $160,000,000.

I think we are the largest in our field, and probably represent in the neighborhood of 75 percent of the face-amount business of the United States.

We have gone over this bill very carefully with representatives of the Securities and Exchange Commission. We are in agreement with them and are very much gratified to have the bill.

Senator WAGNER. Do you think it important for the investment-trust industry that a regulatory bill of this character be enacted into law by the Congress?

Mr. CRABB. Yes, sir.

Senator WAGNER. Well, I might say that that has been the attitude of all other representatives of the investment trust industry affected by this legislation. They have been cooperative, and I think this legislation represents a very sound approach to the problem of regulation.

Mr. CRABB. We feel that that is true.

Senator HERRING. What agreement, if any, was reached as to deposits placed in States for the purpose of guaranteeing certificate holders in States.

Mr. CRABB. That is covered by section 28 (b), I believe.

Mr. SCHENKER. It is section 29, is it not?

Mr. CRABB. I believe it is section 28 (c).

Senator WAGNER. On what page of the bill is that to be found?

Mr. CRABB. Page 107.

Mr. SCHENKER. Might I explain that, Senator Herring?

Senator HERRING. Yes; if you please.

STATEMENT OF DAVID SCHENKER, CHIEF COUNSEL, INVESTMENT TRUST STUDY, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D. C.

Mr. SCHENKER. The way the proposed law is set up, the Investors' Syndicate may form a new company after the enactment of this bill. They may stop selling in the old company, although they will make collections on certificates, so that this bill in no way, Senator Herring, touches deposits that have been made to secure certificates issued up to the time of the passage of this bill.

With respect to future certificates which will be sold—in the event a State law requires a deposit the company has the right to make the

deposit. If such deposit is made and the company goes bankrupt, then certificate holders of a State in which the deposit was made will get a preference with respect to moneys realized on liquidation of this collateral. In event certificate holders in another State do not have the same amount of collateral deposited in their State, enough collateral to pay them in full, then the bill provides that people in a particular State who had a deposit upon which they realized some payment will have to wait until the residents of other States receive an amount equal to the amount that the people living in the States having deposits received, and from there on they all share pari passu.

So we have not abolished deposits, but since the Congress is legislating on a national basis we wanted to have an equalization provision, to the end that a resident of one State will not be preferred over a resident of another State.

Senator HERRING. It will be just a question of whether a State will be willing for a company to do business in that State. In the case of our State, we will expect protection for certificate holders.

Mr. SCHENKER. The fact that this bill provides that such a deposit can be made, and the deposit can be of any size, I think will meet that situation. But a company can only get credit with respect to certain reserve provisions deposited under the law of the State. In other words, this bill does not prevent any State in the future insisting upon a deposit for the protection of its certificate holders.

Senator WAGNER. In other words, it does not change the present status.

Mr. SCHENKER. No; except to this extent——

Senator WAGNER (continuing). I mean, so far as the requirement of a deposit is concerned.

Mr. SCHENKER. That is right. The only change the bill does make is this—and it is really not a change, but an addition: The addition is that where you have a deposit in a State, and the certificate holders get a sum of money on that deposit, they cannot share in the general funds of the company until other people receive an amount equal to what the people in that State receive. So that if a security commissioner of a State has a 100 percent deposit and a company goes bankrupt, the deposit he holds will be liquidated and certificate holders in that State will receive the money and be paid in full.

If a securities commissioner of a State has a deposit which he thought was sufficient in the first instance to pay in full, but in the process of liquidation the collateral realizes less, then the certificate holders do not get 100 percent, but, say, 95 percent. That means that the residents of other States would have to get 95 percent, and then they all would share equally after that.

Senator HUGHES. But they get the full benefit of their deposit?

Mr. SCHENKER. Yes. And the securities commissioner of a State can require a deposit in any amount he wants.

Senator HERRING. I think that is all right.

Mr. SCHENKER. I believe we have nothing further to present.

Senator WAGNER. Is there anything else to be presented? [A pause without response.] Before we resolve ourselves into executive session to vote on the bill does any member of the subcommittee wish to ask any representatives of the investment trusts who may be present any questions with reference to the bill?

Senator Downey. Do I understand that the representatives of the investment trusts and of the Securities and Exchange Commission are virtually in agreement now?

Senator Wagner. Not virtually but actually in agreement.

Senator Downey. That is a most amazing thing in this chaotic world right now.

Senator Wagner. I think it is.

Senator Downey. It is really the first encouraging thing I have heard in several weeks. How was this miracle brought about?

Mr. Schenker. I think I might fairly say that a great deal of it is attributable to the cooperative spirit of the industry.

Senator Downey. I am glad to hear that and hope it is an index of what we may expect from now on.

Senator Herring. Mr. Schenker, could you not say a kind word for the subcommittee?

Mr. Schenker. Certainly.

Senator Wagner. It is another illustration of the value of cooperation. I do not care to recall particularly the fact that I was Chairman of the National Labor Relations Board, in addition to being a Senator. It was a busy time, let me tell you, along in 1933 and 1934. I learned that notwithstanding people may appear to be very far apart, yet when they actually sit down at a table and look at one another and talk to one another, in 99 cases out of 100 they reach an agreement. I think all too often we keep apart when we should sit down and talk things over.

Senator Hughes. Mr. Chairman, I think you should hold that job now.

Senator Wagner. Oh, I do not know about that, but was merely trying to point out what can be achieved when people are willing to cooperate by sitting down and talking over their differences.

Mr. Healy. I think we ought to give full credit to the members of this subcommittee; and I think, further, that Mr. Jaretzki, counsel for the closed-end investment trusts and Mr. Motley, counsel for the open-end companies, have been very patient and very able in handling their end of this matter. I think they are entitled to a large share of the credit, if there is any.

Senator Wagner. I am willing they shall have it. We recognize Mr. Jaretzki in New York as not only a very able and very conscientious attorney but one who is interested in public affairs.

Senator Downey. Mr. Chairman, is it not a fact that generally conscientiousness and ability go together in the legal profession? You seemed to emphasize one of them.

Senator Wagner. Oh, no. I was just explaining how we in New York feel about Mr. Jaretzki.

STATEMENT OF ALFRED JARETZKI, JR., MEMBER OF THE FIRM OF SULLIVAN & CROMWELL, NEW YORK CITY

Mr. Jaretzki. Might I just say this in response to Senator Herring's suggestion: I think both the representatives of the Securities and Exchange Commission and of our group have been very conscious throughout our discussions of the point of view of the members of this subcommittee as indicated by the various questions propounded during the hearings. I think we have endeavored to be guided, in

reaching this agreement on recommendations, by the thoughts expressed by the members of this subcommittee. I hope we have satisfied the subcommittee in doing that.

Senator WAGNER. The subcommittee had that in mind very early in the hearings, because Senators generally mentioned that fact to me. They wondered why the representatives of the investment trust industry and of the Securities and Exchange Commission could not get together and guide us in this matter.

We now wish to thank you gentlemen, one and all. We will go into executive session and consider the bill.

Will you stay around for a short time in order to be available in event any member of the subcommittee wishes to ask you any question?

Mr. HEALY. Certainly, Mr. Chairman.

(Thereupon at 11:12 a. m., Tuesday, June 4, 1940, the subcommittee went into executive session.)

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